

# Stegent Equity Advisors, Inc. Investment Letter

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## Market Review

October 2020

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The third quarter of 2020 saw equities continue their torrid rebound off the March low, with the S&P 500 Index gaining another 8.5%. However, after the S&P reached a new record high of 3,580 in early September, stocks finally hit a speedbump and the index fell by nearly 10% over the next couple of weeks. While a fairly run of the mill pullback by typical market standards, more unnerving was the fact that high-flying Technology stocks led the downturn, and sold off more heavily than the broad index. The tech-heavy NASDAQ 100 Index fell by nearly 13%, which did create some fear that a tech-led crash was going to cause another broad market plunge. However, the move lower proved to be short-lived, and by the end of the quarter, the correction had seemingly ended, as equities found their footing and began rising again.

In other asset classes, moves in the bond market remained remarkably muted, with the yield on the 10-year Treasury bond staying within a range of 0.50% to 0.75% during the quarter. Higher quality bonds lagged, while more credit sensitive bonds rose, led by junk bonds. Broad commodities outperformed both stocks and bonds, gaining nearly 11%. The gains were led by industrial and agricultural commodity prices that perked up as the economy improved and inflation percolated.

### Is This a V-Shaped Recovery?

There is plenty of debate among economists and market strategists about what the ultimate shape of the economic rebound from the pandemic-induced recession might be. A growing list of letters of the alphabet are being used to support their arguments, with skeptics contending that it will take the form of a K, U, or W... all of which suggest that the recovery will soon falter in one way or another. With the daily number of cases across the country on the rise again, there is certainly risk that the recovery might stumble at some point. However, up until now, and contrary to virtually all expectations, one can argue that it's been anything but V-shaped, which raises the question of whether or not the economy is already out of the woods.

As we survey the economic landscape, it's apparent that a variety of economic data has been snapping back in a manner similar to the pattern that typically unfolds following a recession. In just the past five months since the April nadir in the economy, the unemployment rate has fallen from a high of 14.7% to 7.9%; the total value of retail sales has already surpassed its pre-pandemic level underscoring that consumers are still spending even if more is being done online now; and thanks to record low mortgage rates, new home sales have soared from an annual pace of 623,000 to 1.01 million, which is the highest level since September 2006. Overall, after experiencing the worst contraction in GDP since the 1940s in the second quarter, forecasting models for the third quarter (such as the Atlanta Fed's GDP Now) anticipate a 35% annualized gain for the third quarter. These improvements have certainly been jumpstarted by massive stimulus efforts on the part of both Congress and the Federal Reserve. And given that support, there seems to be solid momentum behind the upturn.

Granted, there are still significant challenges facing the economy, with much of the pain most acutely felt in service-related sectors which are still reeling from the impact of the pandemic (including travel, hospitality, and traditional retail stores). While the unemployment rate has come down significantly, there are still nearly 11 million more unemployed workers compared to prior to the onset of the pandemic in February. Many of those are employed in the types of jobs that were unable to quickly transition to a "work from home" environment, and are left agonizing when or even if they'll be able to return to work. When viewed from that perspective, another fiscal stimulus package seems necessary to provide enough support to help keep the recovery going until these service-related sectors are able to recover, but Congress seems to be in a stalemate on that issue at the moment.

At this point in the recovery, there's been plenty of evidence to support the notion that the recovery has been V-shaped. The big question is whether or not this can continue. The pace of the improvement is certain to slow as the economy moves further away from the initial ricochet from very depressed levels in the spring. However, as a base case, we believe that even if it flattens out, the recovery is likely to continue. There's even a chance that the economy could surprise to the upside next year, as long as another wave of the coronavirus doesn't cause governments to shut down the broader economy.

### **New Inflation Framework?**

Like countless other events that have been disrupted by the ongoing pandemic, the Federal Reserve's summer symposium at Jackson Hole was held virtually this year. This annual gathering of academics and other luminaries from the world of monetary policy is always closely watched by market participants, since it is often used as an opportunity to lay the groundwork for important policy shifts. Despite the lack of an in-person presence, this year did not disappoint. Fed Chair Jay Powell used his keynote address to discuss the idea of the Fed transitioning to a new inflation targeting framework in which there would be "symmetry" around their previous 2% target for inflation. That means that in the future, they'll be willing to tolerate inflation rising above 2% to try to make up for previous shortfalls. The reason for this change is that the Fed has grown frustrated that despite their herculean efforts at money printing, for most of the past decade their preferred measure of inflation has remained well below 2%.

Following that, at the Fed's regularly scheduled meeting in September, they confirmed and expanded upon these ideas. The meeting also included an update to the Fed's "dot plot," which shows the Federal Open Market Committee's forecast for where the Federal Funds rate will be over the next several years. After Jackson Hole—and in line with their new plan to proceed very cautiously as long as inflation remains low—the dot plot now suggests that the Fed Funds Rate will remain at zero through 2023, at least. Many Fed observers believe strongly that, based on their new framework, short-term rates could remain at zero well beyond that. In addition, the Fed also seemed to acknowledge that the bar for taking additional measures to increase the amount of monetary support is fairly low.

What this means for investors is that the Fed is going even further out of their way to communicate that they're in no hurry to raise short-term interest rates anytime soon, even if the economic rebound continues to gain steam. The Fed had already taken extraordinary emergency measures to provide liquidity to improve market functioning and to attempt to "shock" the economy back to life after it nearly flatlined. With market functions largely returning to normal, and asset prices rallying strongly since then, the Fed is now looking ahead and trying to come up with new ways to provide ongoing support. Not only is the "Fed put" alive and well, but it's been strengthened. From an investor's standpoint, this is clearly a bullish development for stocks.

### **The Election Looms...**

The upcoming presidential election was already a hot-button issue coming into this year, and the pandemic has only added fuel to the fire. Additional uncertainty has been entered into the equation, due to an anticipated surge in mail-in voting, which brings with it the possibility of a delayed or contested result. Despite these unusual challenges, with less than a month until election day, the market has increasingly turned its attention to the potential outcome. We certainly don't pretend to be election experts, but like most other market participants we are following along with the latest polling data which indicate that former Vice President Biden's lead continues to widen. While a lot can happen, even in the span of two weeks, at this point it seems prudent to consider what the ramifications of a change in administrations could mean for investors.

The prospect of higher taxes under a Democratic administration is something that seems alarming for many investors. On its own, higher taxes, particularly on U.S. corporations, would imply lower after-tax returns for stocks and perhaps usher in a



market downturn. However, there might be some important offsets this time around that work to mitigate the headwinds created by a higher tax environment. Specifically, expectations are that along with tax increases there would also be another significant increase in fiscal spending, which would help temporarily boost economic growth. Under normal circumstances, adding even more to an already severely bloated federal deficit might spook the bond market, and lead to a bout of market volatility. However, with the Fed signaling that it's going to remain extremely supportive by holding the Fed Funds rate at zero for several years, financing large deficits seems "manageable" with interest rates near zero. At some point down the road, that issue will bubble to the surface, but it shouldn't be a near-term concern in our judgement.

Perhaps more importantly, beyond the possibility of some short-term market volatility in the immediate aftermath of the election, the most lasting consequences will likely be at the sector and industry level. We have already begun the process of identifying potential winners and losers within the market, depending on the election outcome. For different reasons, sectors like health care, technology, industrials, financials and energy all seem to have a lot riding on which party will be in power for the next four years. Based on recent market activity, investors seem to be placing their bets on some of these areas already.

### Positioning & Outlook

After a flurry of transactions in the first and second quarters, portfolio activity was more muted in the third quarter. Overall, our portfolios are currently positioned defensively with cash levels above neutral. In terms of positioning, we continue to overweight technology sectors of the equity market which tend to benefit when the economy is recovering, as well as the work/learn-from-home environment most of the world has adapted.

In fixed income, the overall interest rate sensitivity of our bond portfolio is slightly below neutral, with an overweight to high quality credit areas such as long-term Treasuries, mortgages, investment grade corporates and preferred stocks. With the near zero rate of interest on bonds, we have begun using some EFTs that rotate the investment strategy among various types of bonds or even into inflation hedging assets as market conditions change.

Within commodities, we continue to overweight gold, which has mostly moved sideways after a large rally earlier in the year. In our view, gold still seems undervalued in an environment of ultra-low interest rates, unlimited money printing and government stimulus, and resulting inflation.

Continuing with our theme of hedging against inflation, we have added a small allocation to Bitcoin and the technologies powering and enabling the blockchain and cryptocurrencies. Entire books and movies have been made trying to explain the concepts and benefits of digital money, but here's a short summary explanation... Bitcoin is a cryptocurrency that was created in 2009. It's a digital asset that isn't controlled by any person or government. And it operates completely outside of the traditional banking system.

Bitcoin can be transferred to anyone with a "digital wallet" anywhere in the world securely, cheaply, and almost instantaneously. The technology that enables such transactions to occur is the blockchain. The blockchain is basically a database or ledger. But the key innovation is that it's a ledger that is distributed across the entire network, so that everyone can see all the data on every transaction and verify their accuracy.

In other words, we can trust the blockchain to maintain the system's fairness and integrity, instead of having to trust other bitcoin users. This provides an inherent advantage for bitcoin over most other forms of transactions, which need a trusted, independent (and often handsomely paid) third party to ensure fair transfer.

## How Does Bitcoin Fit into a Portfolio?

Every investment portfolio, whatever your goals may be, really needs only two main kinds of assets: productive assets and stores of value.

Productive assets are your workhorse investments that will generally account for the majority of your portfolio and contribute most of your overall gains. These assets are "productive" in that they generate a rate of return greater than their cost of capital (and inflation).

Examples of such assets include public stocks, high-yield bonds, private company investments and income-producing real estate.

Stores of value should make up the rest of your portfolio. This is your reserve (or "cache") of safe capital that you expect to essentially maintain its value over time. It's also your store of "dry powder" that you can opportunistically deploy into productive assets after a major market sell-off.

Examples of stores of value that have been widely used over time include cash, U.S. Treasury bonds, gold, and non-income producing real estate assets.

Generally speaking, the more you seek portfolio safety over high returns, the more your portfolio should tilt toward stores of value.

With that in mind, where does bitcoin fit in? Is it a productive asset or a store of value?

The most ardent bitcoin bulls will argue that it's more of a productive asset. They see bitcoin as the transactional currency and network that will transform financial markets around the globe. But mostly, they're just seduced by bitcoin's extreme growth in value from \$0.05 per bitcoin in 2010 to more than \$13,000 per bitcoin today.

If you invested \$1,000 in bitcoin back then, it would be worth more than \$300 million now. So, you can see where they're coming from.

But in truth, there's nothing inherently "productive" about bitcoin. It doesn't produce earnings or cash flow. It doesn't pay dividends or interest. And you can't really value bitcoin like a traditional stock or bond.

No, unless financial markets change completely, bitcoin is decidedly not a productive asset.

So then, is it a store of value? The key to a store of value is that it needs to maintain its value over time. Bitcoin bears would point out plenty of instances where the crypto asset's price went sour faster than a gallon of milk (including losing nearly half its value in one day).

It's true that bitcoin's price has been extremely volatile over short timeframes. And that restricts its use as a store of value for those funds you'd need to access sooner rather than later. But time and again, it has proven itself as an excellent store of value over the longer run. And given current global market and economic forces, we believe bitcoin will prove to be the single best store of value on the planet over the next decade or more.

## Conclusion

At this point, we do not anticipate making additional major changes to portfolio construction before the election. If there is some market volatility surrounding that event, we will use that opportunity to deploy the cash that we have built as a hedge. And, depending on the outcome, there could be further adjustments in term of our positioning, both within the U.S. equity market and also potentially in terms of weightings, between U.S. and International equities. In the meantime, we will continue to gather a list of potential investment ideas to act on as the dust settles.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

A handwritten signature in black ink, appearing to read "Lloyd J. Stegent". The signature is fluid and cursive, with the first name "Lloyd" and last name "Stegent" clearly distinguishable.

Lloyd J. Stegent, President  
Stegent Equity Advisors, Inc.