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Below please find excerpts from our Q3 report to clients. Yes, I know I am not known for brevity, but this update was actually a short one!

Most importantly, I hope you are continuing to stay healthy and safe. Three months ago, the single most asked question which happened to be the single most asked question of my 32-year career, was "how can the stock market behave so well when the economy was basically in a modern-day depression?" That question's prominence took a backseat to all sorts of questions about the election. For those of you on the recent webinar, you heard me begin to address the various outcomes and market impact. I will expand on this topic in great detail later in October on another webinar which I have already emailed the method to register.

As I sat down to collect my thoughts and start this report, I realized that this is the third update since COVID hit our shores. It certainly feels like it has been a lot longer. While life is definitely different than it was in February, I feel like people, overall, are not as vigilant nor acutely concerned as they were three and six months ago. As Americans typically do, the longer something goes on, the more we adapt and adjust to the new normal. That kind of behavior is engrained in us and has served us well over the decades. However, it may also be hindering our collective ability to get ahead of the virus.

Compared to Q1 and Q2, the past three months were on the tame side. Of course, that's on a relative basis. COVID and the election dominated the landscape although there was a lot more going on in the U.S. and around the world. Black Lives Matter and urban protests were widespread in several major cities as the racial divide was about as strong as it has been in decades. After many years of pressure to change their name, the Washington Redskins and really, their owner, succumbed to public outcries and removed Redskins from their name. It will be interesting to see if this trend continues in the future at the pro and college level.

On the topic of sports, Q3 saw all the major professional leagues come back to action in some form. Whether you enjoy sports or not, this felt like an important step for America to have some semblance of normalcy return to our lives. Let's hope that remains the theme throughout winter as there will be less to do as the weather turns. And speaking of weather, Mother Nature remained angry with a record number of named Atlantic storms as well catastrophic fires in California.

While most of the events had no economic nor market impact, natural disasters certainly do as the rebuilding process often takes years and doesn't just replace what was lost. Buildings and infrastructure are brought up to current day standards at a much higher cost. This means more jobs and more money spent which lead to stronger local economies.

As I continue to mention, COVID itself has been an economic catastrophe, the likes of which has not been seen since the 1930s. There is no playbook to follow, no historical analog. We know that the Federal Reserve did the opposite of what they were supposed to do in the early 1930s. In 2008, they were asleep at the switch and failed to act in a timely manner. In 2020, they reacted immediately; some even say they overreacted. The trillions they pumped into the markets and economy certainly prevented a repeat of the early 1930s. However, the reopening of the country continues to be very uneven and regional.

History will show that the shortest and one of the deepest recessions in history ended in Q2 although I remain firm that there will not be a "V" recovery, a position I have held since the virus hit. In Q3 we learned that Q2 GDP fell at an annual rate of 32.9%, the largest quarterly decline since records began in 1974. Unemployment has gone from a generational low of 3.5% in Q1 to 15% in Q2 to less than 10% in Q3. That kind of volatility has no historic equivalent. Retail sales have already passed pre-virus levels as pent up demand, very generous unemployment benefits and stimulus checks have led to a torrent of economic activity. Thanks to record low mortgage rates, the non-urban housing market is as strong and active as it's ever been, leading to a shortage of single-family inventory.

The economy and financial markets are on constant COVID watch for therapeutic and vaccine updates. As we have seen, both positive and negative news can hit at any time. With so many global companies working on the virus, we can expect clinical trial updates straight through to 2022. The world is depending on it. While some have speculated that summer would “burn out” the virus or it would disappear, the first wave never truly ended. With fall here, what was expected to be a second wave has turned out to be an extension of what began in February.

The good news is that there are now plenty of ventilators, PPE and hospital beds. The medical community has the benefit of the past 8 months to guide them on treatment, not to mention that the majority of the country is more prepared with masks, social distancing and hygienic practices. It’s not fun, but at least we are collectively learning how to be as safe as possible without doing further damage to the economy.

As questions still surface about how the markets can behave in the face of bad headlines, please remember one of my favorite adages that I have followed for 30 years. It’s not what the news actually is, but rather, how markets react. The most positive thing a market can do is go up in the face of bad news. Conversely, the most negative thing a market can do is go down in the face of good news.

Turning to the election, depending on when you read this report, my comments may already be a moot point. I gave a webinar in mid-October based solely on data where I showed the various studies and which candidate they favor. No president has ever been reelected with recession or a bear market in the election year. Additionally, no president has ever been reelected with an approval rating of less than 47% on July 31. The last three elections in years ending in "0" saw the incumbent lose. All those factors favor Joe Biden winning the election. However, no original frontrunner from the Democrats has ever won the election.

Looking at what the markets say, the stronger the stock market into the election, the more likely it is for the incumbent to win. Right now, that's a toss-up. Our own internal election model uses data right through the Friday before the election. The model is leaning to Biden, but I will update this and circulate the call before election day. The last time the model was wrong was in 1992.

Staying on the theme of the election, contrary to what the pundits and media have been saying, the closer we get to an incumbent election, the less volatile the markets. All this talk of stock market crashes and collapses because one candidate is going to win or no candidate is going to win or a big, colored wave or the lack of a peaceful transition of power is 100% nonsense and garbage that isn't supported by any data.

September and October in incumbent election years are notoriously quiet. Sure, the stock market will go up and down, but not only well within the realm of normalcy, but even less so. Given the unprecedented angst over this election, I have very high conviction that whatever decline the market has will find a bottom before election day and rally strongly after the day, regardless of who wins.

Pivoting to the economy and markets, there are two things that I have long believed and said. The first is that I firmly believe a president's "economic destiny" is decided long before he becomes president. This will come across as counterintuitive, but it is much better for a president to assume power during difficult times than successful ones as expectations are set very low and it is easy to blame the previous administration for all that ails the country.

Ronald Reagan could not have won at a better time. Our economy was generally poor throughout the 1970s due to systemic inflation with an oil embargo mixed in. The market yielded no gains since the late 1960s and Americans were very down on our future as interest rates soared to record levels. What was the worst Reagan could do? Keep the status quo? Instead, Paul Volker and the Fed engineered a recession by continuing to hike rates and get inflation under control. Along with years of pent up demand and pessimism, the Fed set the stage for one of the greatest economic booms of the modern era. It also didn't hurt that Reagan ran on rebuilding our defense and military through massive deficit spending.

George W. Bush is an example of taking over at precisely the wrong time. Bill Clinton presided over an amazing economic and stock market run that culminated with the Dotcom Bubble. It was a new era, a new paradigm. But by the time the Bush/Gore election came, the economy was already weakening and close to recession. The stock market had seen its bull market peak in March 2000 and the tragedy of 9-11 was just around the corner. It wouldn't have mattered who won the election of 2000, the coming few years were going to be challenging through no fault of Bush.

The winner of the 2020 election should have easier times, even if the economy softens a little over the winter due to COVID restrictions. Vaccines and therapeutics are coming in 2021 and the hardest hit sectors of the economy should finally begin to recover strongly and for good by Q2 or Q3.

Over the past few quarters, I struggled to assign a letter to how I thought the economy would recover and I have been adamant that there would be no "V" recovery, a position I still hold. Although Q3 likely saw record growth in excess of 25%, the recovery remains lumpy and very uneven, but there is a bright light at the end of the tunnel on its way.

Three months ago, I wrote:

"Longtime clients know that I haven't written about inflation being a problem since well before the financial crisis. In fact, I have been on the polar opposite side, worrying about disinflation or deflation... I believe the deflation/inflation tide is finally about to turn, but perhaps not for the reasons you would think. I absolutely do not think it is because the Fed and government created and/or borrowed many trillions of dollars. That's a fool's errand. Whatever the Fed and government do won't nearly replace what was lost during the pandemic. My data look like there is risk for old fashioned commodity inflation, starting with the food complex. The next three to five years or more could see higher prices resulting from climate change, supply chain disruptions or geopolitics. If that scenario plays out, the next few years could see substandard economic growth with higher inflation. Some would call that stagflation."

I repeat that because data and price action have confirmed my thesis. The inflation genie is out of the bottle, not to a worrisome level, but rather somewhat healthy right now and for the foreseeable future. The price of commodities has risen very quietly since the end of June at a pace not seen since 2014. It is something to definitely keep an eye on, especially if shortages do not abate over the coming months.

Q4 should see a continuation of the economic recovery although not even close to the breakneck pace of Q3 unless Congress passes another massive stimulus plan. Young bull markets rarely see declines of greater than 10% in their first year and this one should be no different. Any and all weakness surrounding the election should be viewed as a buying opportunity until proven otherwise. Jay Powell and his friends at the Fed will continue printing money like never before seen in this country. Japan would be proud. Long-term interest rates should start to fight back and rise which may force the Fed to go beyond buying bonds and start a program to manage the yield curve or all interest rate levels.

The first three quarters of 2020 has shown, once again, that our economy and consumers can sustain generational damage, yet remain resilient. Of course, the lightning fast bilateral response from the Federal Reserve and U.S. government prevented a complete and utter collapse, akin to a modern-day depression. Financial markets are strong. There is a tsunami of liquidity courtesy of the Fed and the economy continues to improve. Although the stock market will likely experience another short, sharp pocket of turbulence over the coming few months, the young bull market remains intact and the uneven, lumpy economic recovery should broaden out over time.

As the country heads into what looks like a dark winter with the virus, please remember my career long adage. It's not what the actual news is, but rather how markets react. The health crisis is an epic tragedy, but the financial markets are behaving like the country is already on the other side in 2021.

While we are always very appreciative of your support and loyalty, we are especially so right now. Although we can only meet via Skype, Zoom or the phone, we are happy to schedule meetings most days of the week. Please continue to share your feedback, positive and negative. Investing is a marathon not a sprint and the long-term future continues to look very, very bright. We look forward to sharing that with you over the coming years. Again, here is the link to my calendar to schedule a call, Zoom meeting or Skype. https://schedulewithpaul.as.me/

Thank you for the privilege of serving as your investment adviser! Please stay healthy and sane!!

Sincerely,

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To Your Financial Success,

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