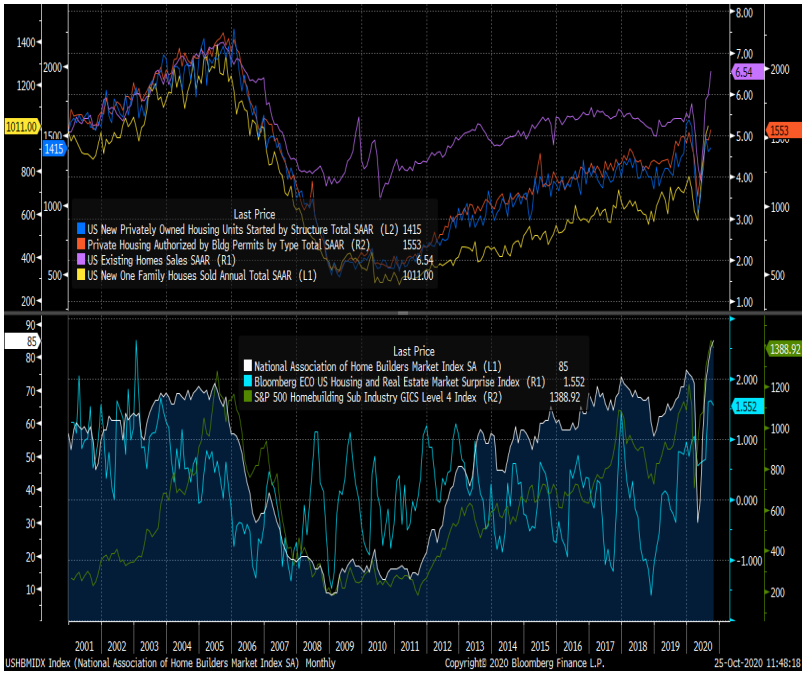
STONE INVESTMENT PARTNERS LLC

Weekly Market Guide | October 26, 2020

CHART OF THE WEEK – THE BIG SHORT REVISITED



Source: Stone Investment Partners, Bloomberg as of 10/25/2020

In between watching football games this weekend, I took the opportunity to re-watch *The Big Short*. The movie is based on Michael Lewis' book of the same name which chronicled the housing bubble and financial crisis of the late 2000s. I highly recommend both and personally have a soft spot in my heart for Michael Lewis as he introduced me to Wall Street and my eventual first employer via my reading of *Liar's Poker*. While we often say that a current situation rhymes with the past, our current COVID crisis is much more of an external shock to the economy akin to a natural disaster than a financial crisis. This is relatively good news as the U.S. did not have a bubble in housing or weakness in the banking system going into this crisis. U.S. banks remain very well capitalized though continued high unemployment rates could translate into future loan losses. In fact, housing is a strength in this recovery as space has become a high priority propelling housing data to levels not seen since the housing bubble of the late 2000s (see chart). The September housing data released last week was strong with new and pending home sales this week likely to continue the trend. In addition, spending on housing related sectors like furniture have benefitted and rebounded to above pre-COVID levels. The swiftness of the economic bounce with 3Q GDP likely growing by more than 30% annualized when it is announced this week is reflective of a recovery from an external shock rather than the slower rebound that typically accompanies a financial crisis. To be sure many parts of the economy like restaurants, travel and services are still significantly pandemic-impacted and suffering both in terms of the sales and employment recovery. While the pace of economic growth will certainly slow in 4Q and beyond, the opportunity remains for a better than currently expected recovery in the economy and corporate earnings if there is continued progress on a COVID vaccine and/or therapeutics.

WEEK IN PREVIEW

- Geopolitical: The Senate is scheduled to vote Monday on the Supreme Court nomination of Amy Coney Barrett. The CEOs of Facebook (FB), Google (GOOG), and Twitter (TWTR) will testify before the Senate Commerce Committee on Wednesday which could spur calls for further regulation of the technology giants. Talks between the European Union (E.U.) and U.K. as to the details of their future trade relationship will continue to make headlines but at least some deal seems likely eventually. The Chinese Communist Party plenum is being held to plan the future of the economy. Localized lockdown measures continue in many parts of the globe to combat the resurgence in COVID-19 infections, so the impact on economic activity will be closely monitored but revisiting wholesale lockdowns is unlikely.
- U.S.: Though it is backward looking, there will be much interest in the 3Q GDP report which should post a record high growth rate of more than 30% annualized. The Atlanta and New York Fed's estimate of 3Q GDP growth are 35.3% and 13.8%, respectively. September durable goods orders along with personal income and spending will also be closely watched. Initial jobless claims will be monitored for a high frequency look at the labor market. Mercifully little Fedspeak with only one speech on the calendar after a busy couple of weeks. Readings for our **U.S. Reopening Monitor** remained net positive but new COVID-19 cases and deaths rose on a week-over-week (W/W) basis. Underlying high frequency economic data was mixed with public transit, retail sales and dining improving while the consumer sentiment and airline travel measures took a step back. Please see our ***Guide to the U.S. Reopening Monitor*** for more details.
- S&P 500 3Q Earnings: The 3Q earnings season has its busiest week with 183 S&P 500 companies scheduled. With 27% of companies reporting 84% and 81% have beaten earnings and sales estimates, respectively. According to FactSet if 3Q ends with an 84% beat rate on earnings, it would be the highest level recorded since they began tracking in 2008. 3Q blended earnings (combining actual results with estimates) improved to -16.5% from -18.4% year-over-year (Y/Y) last week. This improvement was primarily driven by better actual earnings from the financials, healthcare and consumer staples. As detailed previously, we continue to expect 3Q earnings to beat the -20.5% Y/Y estimates.
- Europe: Confirmed COVID cases have risen on a W/W basis for sixteen straight weeks in the Eurozone. More restrictions have been enacted which has weighed heavily on services including dining and given rise to fears of a double-dip recession. France, Germany, Italy, Spain and the U.K. hit an all-time high weekly infection pace. The Eurozone reports 3Q GDP which should bounce sharply higher. The European Central Bank (ECB) meets and is likely to at least signal if not implement further asset purchases given the weight of COVID infections and Brexit uncertainty. The U.K. pace of infections increased for the eighth week despite tighter curbs. Please see our **U.S. Reopening Monitor** for additional international COVID charts and data.
- Asia: October China official PMI data should continue to reflect the rebound in growth as their domestic economy was the first impacted by COVID and now benefiting from the global recovery. Japan posted a decline in the pace of weekly infections. Japan reports its monthly employment data for September with the unemployment rate expected to tick up to 3.1%. Japanese PM Suga is scheduled to give his first policy speech. The Bank of Japan (BOJ) meets with no change in policy expected but growth estimates could be reduced.
- Central Banks: In addition to the ECB and BOJ, the central banks of Kazakhstan, Canada, Brazil, Georgia, and Colombia are scheduled to meet with none expected to change their policy rate.

WEEK IN REVIEW

- Stocks fell by -0.5% for the S&P 500 with only four of eleven sectors higher for the week. Communication services (2.1%), utilities (1.2%) and financials (1.0%) outperformed the S&P 500, while technology (-2.2%), consumer staples (-1.4%) and real estate (-1.3%) were the biggest laggards. WTI (-2.5%) and Brent (2.7%) oil were lower with MLPs (4.0%) and the energy sector (0.5%) higher.
- Large cap value as measured by the Russell 1000 Value outperformed at 0.2%. Banks performed very well with the Invesco KBW Bank ETF (KBWB) higher by 3.6%. High dividend strategies outperformed the S&P 500 with the iShares Select Dividend ETF (DVY) at 1.4%. Momentum underperformed with the iShares MSCI Momentum ETF (MTUM) falling -2.1%. Small-cap stocks outperformed relative to the S&P 500 with the Russell 2000 higher by 0.4% and small-cap value stocks outperforming at 1.9%. The 10-year and 30-year U.S. Treasury yields were higher at 0.84% and 1.64% respectively.
- High yield credit spreads narrowed slightly reflecting increased risk appetite. AAA municipal bond yields as a percentage of Treasuries fell, causing municipal bonds to outperform. The negative revenue impacts of the economic lockdown on local governments and talk of state bankruptcy have driven municipal bond valuations to low levels relative to Treasuries. Between the strong 3Q economic rebound and Federal support so far, states declaring bankruptcy remains an unlikely outcome. Additional support for the states is likely to come in any future stimulus bills, but one of the sticking points to a new deal is the size and distribution of Federal government aid.
- The U.S. dollar was weaker against both developed and emerging market currencies. Developed international stocks as measured by MSCI EAFE outperformed the S&P 500 returns in U.S. dollar terms (0.1%) and underperformed on a hedged-currency basis (-0.6%). MSCI Japan outperformed the S&P 500 returns in U.S. dollar terms (1.1%) and on a hedged-currency basis (0.5%). Emerging market stocks outperformed the S&P 500 with a non-hedged return of 1.1% for MSCI EM.
- The 10-2 yield curve widened to +69 basis points. Another curve measure of three-month yield six quarters forward minus the current three-month yield increased to +10 basis points. The yield curve has historically provided an accurate forecast of future recessions when the difference in these measures turns negative, also known as inversion. Yield curves are one of the major indicators that we monitor to judge recession risk, but these inversions typically happen more than a year in advance of an economic recession. External shocks like the current coronavirus-induced recession might not be accompanied by inversion. Stocks have historically had significant advances post-inversion.

Bill Stone, CFA, CMT
Chief Investment Officer

Disclosures

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