[The Election Going Into Labor]

The Bottom Line:

The stock market pulled back for the first time since early June when COVID-19 cases reemerged. This retreat is more likely due to technical reasons, as August's rally was so hot that it would be difficult to sustain. There also appeared to be some profit-taking / rebalancing activity where "growth" areas of the stock market pulled back more than their counterparts. It makes sense for some consolidation and repricing as we enter election season. This is a trade, not a change in outlook, as economic realities have continuously exceeded expectations during this pandemic recovery.

The Full Story:

This rip-your-face-off rally decided to take a pause heading into Labor Day weekend. Stocks performed extraordinarily well in August, as the major indexes reported returns of +6% to +8%, and growth sectors like technology led the NASDAQ to an +11% return. Coming into this week, 9 out of the 11 economic sectors (energy and utilities were the 2 laggards) of the U.S. market were considered Overbought – measuring more than 1 standard deviation above their 50-day moving averages. The S&P 500 was teetering into Extremely Overbought territory, which is more than 2 standard deviations over its 50-day moving average.

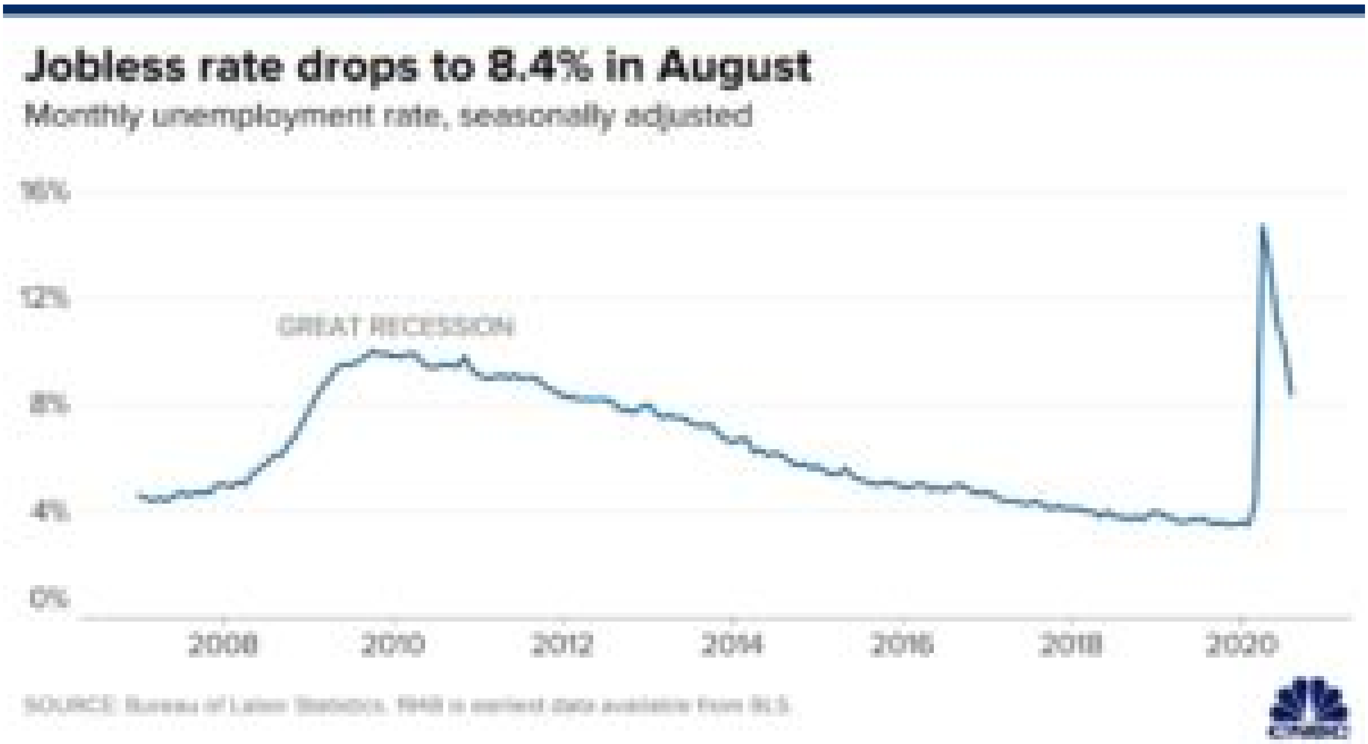
		Returns		
Index	Description	August	Last Week	Last Thursday & Friday
DJ Industrial Average	US "Blue Chip" Stocks	7.92	-1.73	-3.32
MSCI ACWI	Global Stocks	6.12	-2.25	-3.52
MSCI EAFE	Developed International Stocks	5.14	-2.07	-2.21
MSCI EM	Emerging Markets Stocks	2.21	-1.95	-1.72
NASDAQ 100	US Tech. & Discretionary Stocks	11.16	-3.10	-6.42
Russell 2000	US Small Cap Stocks	5.63	-2.70	-3.57
S&P 500	US Large Cap Stocks	7.19	-2.27	-4.28

Source: Morningstar

It makes sense from a technical standpoint for some areas of the market to take a pause and even reverse. As you can see in the chart above, it was a classic mean reversion where the areas that had performed the best over the previous month (technology, communication services, and consumer discretionary i.e. the NASDAQ), performed the worst on Thursday and Friday. These areas are still up big year-to-date and since the March 23rd bottom, but their rally was probably stretched after the August run.

Those are technical measures. The forces that have been propelling stock returns have been economic upside surprises, monetary policy, and a lower level of COVID-19 cases / hospitalizations / deaths.

On the economic front, jobs numbers slightly exceeded expectations at +1.37 million jobs added, and the headline unemployment rate fell to 8.4%. Retail added 249,000 jobs and leisure & hospitality added 174,000 jobs with most coming in bars and restaurants. Those are some of the hardest hit industries during the pandemic, so it is encouraging to see continued recovery in the absence of additional fiscal stimulus.



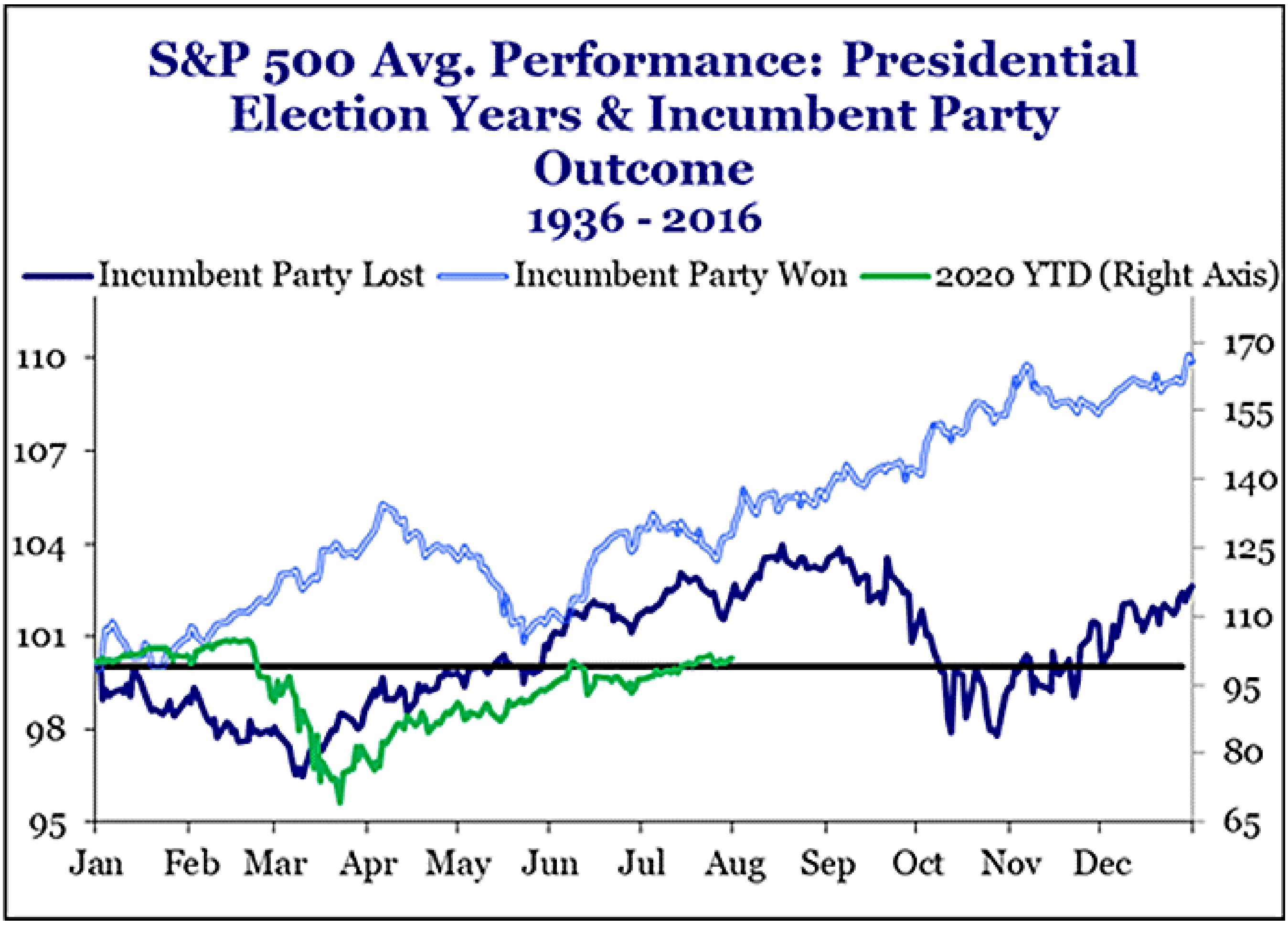
Last week, David touched on a **[shift in Federal Reserve policy]** that continues to support stock prices and higher valuations. The Fed has signaled that interest rates will remain anchored near zero indefinitely. Since asset valuation levels derive from interest rate levels, persistently low interest rate levels support persistently high valuation levels.

Election Speculation

Now that we are less than 2 months out from Election Day, I think we can start some presidential election and stock market speculation. Both the stock market and economy tend to be fairly reliable indicators of election outcomes.

If the S&P 500 is higher in the 3-month period before the election than it was at the beginning of the year, the incumbent party generally tends to win. If the index is lower, the opposition party tends to take the White House. This predictor has been correct 87% of the time over the last almost-100 years, and 100% correct since 1984.

You can note the difference in the chart below. If there is going to be a change in presidential party, we can expect a 5%+ downturn in this period leading up to the election before a rebound to positive territory in November and December. However, even with last week’s downturn, the S&P 500 still sits in positive territory year-to-date (the Dow Jones Industrial Average is flat).



source: Strategas Research Partners

President Trump is fighting an uphill battle to get reelected in a recession year. Historically, if there is an economic recession in the last 2 years of a president's first term, it has led to a one-and-done. It sealed the fate of George H. W. Bush, Jimmy Carter, and Gerald Ford in modern times. The last and only president to survive and advance from a recession in their first term was Calvin Coolidge in 1924.

Recessions Have Historically Crushed Incumbents – No Recession in Two Years Before Election

Recession?	President (Year)	Re-Election?
No	Obama (2012)	Yes
No	Bush 43 (2004)	Yes
No	Clinton (1996)	Yes
No	Reagan (1984)	Yes
No	Nixon (1972)	Yes
No	LBJ (1964)	Yes
No	Ike (1956)	Yes
No	Truman (1948)	Yes
No	FDR (1944)	Yes
No	FDR (1940)	Yes
No	FDR (1936)	Yes
No	Wilson (1916)	Yes
Yes	Bush 41 (1992)	No
Yes	Carter (1980)	No
Yes	Ford (1976)	No
Yes	Hoover (1932)	No
Yes	Coolidge (1924)	Yes
Yes	Taft (1912)	No

source: [illegible], Neuberger Berman

The unusual nature of a virus pandemic-led recession could make it an outlier. However, current forecasts (and oddsmakers if you are into that type of thing) have former Vice President Biden as a favorite. Strategas forecasts Biden's win probability at about 55%, which is a closer race than what polls suggest. But let's remember that polling had difficulties last time around.

To borrow a line from the Ragin' Cajun James Carville, "it's the economy, stupid." I would never talk to our fine clients and readers like that, but he makes a good point. That line came from his time as a strategist during Bill Clinton's 1992 presidential campaign as he unseated George H. W. Bush after the 1990-91 recession. Economic recovery from this point will determine the direction of the stock market through year-end and possibly the direction of the presidential election.

Have a great Sunday and Labor Day weekend!

Timothy W. Ellis, Jr., CPA/PFS, CFP®

Senior Investment Strategist, Wealth Strategist

Sources: Bespoke Investment Group, Morningstar, CNBC, Strategas, FiveThirtyEight, Neuberger Berman