

*“The trouble with too many people is they believe the realm of truth always lies within their vision.”*

Abraham Lincoln (1809-1865)

## IN FOCUS: Implications of a Biden versus Trump Victory

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### ***Some General Observations:***

- The campaign proposals of both Joe Biden and President Trump both appear likely to significantly increase the federal budget deficit and debt in the years ahead, from already projected high levels.
- Biden’s proposals appear to indicate a much more active role for the government in the economy, with the greater possibility of higher spending and taxes compared with current law. The higher tax burden could fall on corporations and upper-income individuals but we believe will most likely be on a phased-in basis given the weakened recovery path that could be hindered by policy overload.
- Trump has provided much less detail about his policy objectives, but what is available implies moderately higher spending and cuts in taxes for individuals.
- Biden’s proposals bode better for economic growth on a 1-2-year horizon given weak current demand, but could present a greater risk down the pike. The direction the U.S. economy takes in year 3 and 4 under a Democratic sweep remains uncertain.
- Although Biden’s fiscal proposals imply higher risks for equities, bonds and the U.S. dollar compared with Trump’s, Biden will likely provide greater policy predictability and has the potential to achieve greater political consensus than President Trump and supports our *stay invested* stance.

## CLOSE-UP: The Economic Landscape as the Fourth Quarter Unfolds

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**Policy proposals are crucial for campaigns, but whether they turn into policy is contingent on any number of factors, some of which are beyond the control of a candidate.** Any assessment of the impact of either Biden’s or Trump’s proposals on the U.S. economy and capital markets must be put into the context of the starting point. U.S. Treasury yields are at extraordinarily low levels, reflecting both the weak economy and aggressive support of the Federal Reserve. U.S. stocks are elevated by historical standards, and consensus expectations for earnings in 2021 are fairly optimistic. The dollar appears expensive and yields are abnormally low.

**We expect the economy to continue to recover, but several sectors will be slow to normalize, depending upon the availability of a COVID-19 vaccine and/or other medical treatments.** Containing and/or eliminating the threat of the pandemic and restoring corporate and consumer confidence will likely be more important contributors to the economic and capital market outlook over the next 1-2 years than the direct monetary impact of either candidate’s proposals. Beyond the 1-2-year horizon, the biggest driver of capital markets will be the underlying growth of the economy and related productivity, and inflation.

**At present, there is little basis for concluding that the plans of either Joe Biden or President Trump will dramatically alter the underlying fundamentals of the U.S. economy that have prevailed for the past two decades.** Biden's proposals are more ambitious and thus have a better chance to enhance long-term growth potential, but they also could entail greater potential downside risk. Given the economic and capital market starting point, the next 1-2 years will be challenging for investors, with lower real returns and greater risk compared with recent decades.

### **A View on Market Valuations – Price/Earnings and Dividend Yield:**

**As you may be aware, the stock market is working on answering this very relevant question these days:** What is the fair-value forward P/E of the S&P 500 when the 10-year U.S. Treasury bond yield is near zero? The answer as of last Friday is a forward P/E of 21.9. Multiplying this forward P/E by forward earnings of \$160 per share last week implies that the S&P 500 was fairly valued.

**Of course, if the latest forward P/E is either too high or too low relative to the fundamentals, this implies the market is actually either overvalued or undervalued.** We have moved towards the fairly valued camp for now given that interest rates remain so close to zero.

**However, focusing on actual dividends rather than forward earnings supports the view that stocks are somewhat undervalued, given that the bond yield is so low.** From a historical perspective, focusing on valuing earnings is a relatively new phenomenon that started with the bull market of the 1990s. Investors compared the dividend yield, not the current earnings yield, to the bond yield. Corporations were valued on their ability to pay and grow dividends, which represented a tangible return to investors. Retained earnings—profits after taxes and dividends—were reinvested in the business, presumably to increase the capacity of the corporation to pay more dividends in the future.

**We have reviewed a number of studies from this framework.** Currently, in October 2020, the takeaway from this analysis is that stocks are attractive relative to bonds because the dividend yield, at 1.75% during Q3, well exceeds the bond yield, and the long-term uptrend in S&P 500 dividends has been roughly 6% since the end of 1946.

### **A Note on the Capital Gains Tax:**

**One anxiety investors' fear in a Biden victory is that a capital gains tax hike could spark a big sell-off in stocks.** We believe that this would not likely result in a broad market decline but only a mild rotation into democratic-friendly equities at least temporarily. We have come to this conclusion because there is virtually no alternative to stocks given that the Federal Reserve is likely to maintain interest rates near zero for the foreseeable future.

**With respect to the capital gains tax, it has been the case that investors historically have sold assets that had appreciated ahead of such tax increases.** But institutions make up the lion's share of investors these days (75% according to recent research from the Tax Policy Center), and they aren't subject to a capital gains tax. Even back in 1986, when this was less the case, equities continued to rise overall even as investors took capital gains before a pending capital gains tax hike.

### **Risks of Market Timing:**

**Periods of uncertainty are understandably difficult psychologically.** Market timing is a natural impulse, especially in the midst of a significant shock to the financial system. We believe this underscores the value of investment objectivity, remaining unemotional, and adhering to a time-tested investment strategy. We have often referenced the historical data like the one below to help highlight the inherent risk in trying to time the markets to avoid downturns. Statistically, it is impossible to pin point exact market peaks and troughs. Looking at market price performance in each decade since the great depression, we can see that if one misses the top performing days, investment returns drop significantly as compared to staying fully invested. Yes, missing the worst trading days meaningfully increases return potential, but keep in mind that to be a successful market timer you have to trade both sides of the transaction precisely. Additionally, the best and worst trading days can at times happen consecutively, making the timing even more difficult. If we just eliminated 2 days during the decline the market lost almost 1/4 of the total drop.

**As we have reviewed, market downturns are unfortunately an inevitable part of investing.** We believe that any liquidation during or even in anticipation of a market shock - in an attempt to time an alternate entry point - is a very high-risk strategy. We are usually not comfortable with this unless the fundamentals warrant a closer examination of the macro and micro data.

#### **Panic-Selling and pullback-timing result in missing the best days**

S&P 500 returns by decade excluding the best and worst days

Decade	Price return	Excluding best 10d per decade	Excluding worst 10d per decade	Excluding best/worst 10d per decade
1930	-42%	-79%	39%	-50%
1940	35%	-14%	136%	51%
1950	257%	167%	425%	293%
1960	54%	14%	107%	54%
1970	17%	-20%	59%	8%
1980	227%	108%	572%	328%
1990	316%	186%	526%	330%
2000	-24%	-62%	57%	-21%
2010	190%	95%	351%	203%
<b>Since 1930</b>	<b>14,962%</b>	<b>91%</b>	<b>1,689,091%</b>	<b>21,323%</b>

Source: S&P, BofA US Equity & Quant Strategy

## **LOOKING AHEAD: Stocks for The Long Haul**

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**Explaining the short-term movement of share prices in rising and falling markets is a very different exercise than owning businesses for the long haul in all sorts of economic cycles.** Looking at the state of the stock market today, we are reminded of the famous investor Benjamin Graham and how distanced stock prices can become from their underlying company fundamentals: “the stock market is a voting machine in the short run rather than a weighing machine in the long run.” The short-term movements of the markets tend to be based on subjective or emotional judgments, rather than any actual change in the value of the securities being traded. We know that in the longer-term markets are driven by something different: gradual changes in the underlying value of the securities being traded.

**As a company's earnings grow incrementally over time, and its business expands, it becomes more valuable.** None of this shows up in coincident trading prices and short-term relative returns, but over the years, the rise in value becomes visible. Our strategy for your financial well-being is to ignore the noise of short-term events and investment performance disparities - and focus on the more durable longer-term trends. Another and more fundamental point is that whenever you put together a portfolio of stocks, you are participating in the growth of the underlying businesses and the economy as a whole. That means that when company workers create value by building enterprises, innovate, and produce goods and services, investors in their stocks participate in the fruits of their labor. The effect can be gradual, but clearly becomes visible if you can look at the longer-term impact on your investments. So, we encourage our investors to exercise patience. Of course, we recognize that we will miss the “hot” stocks - but we believe our discipline should promise both the safety of principal and a reasonable rate of return (relative to risk).

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