ELECTION DAY IS OVER. THERE'S A VACCINE. NOW WHAT?

NOVEMBER 2020

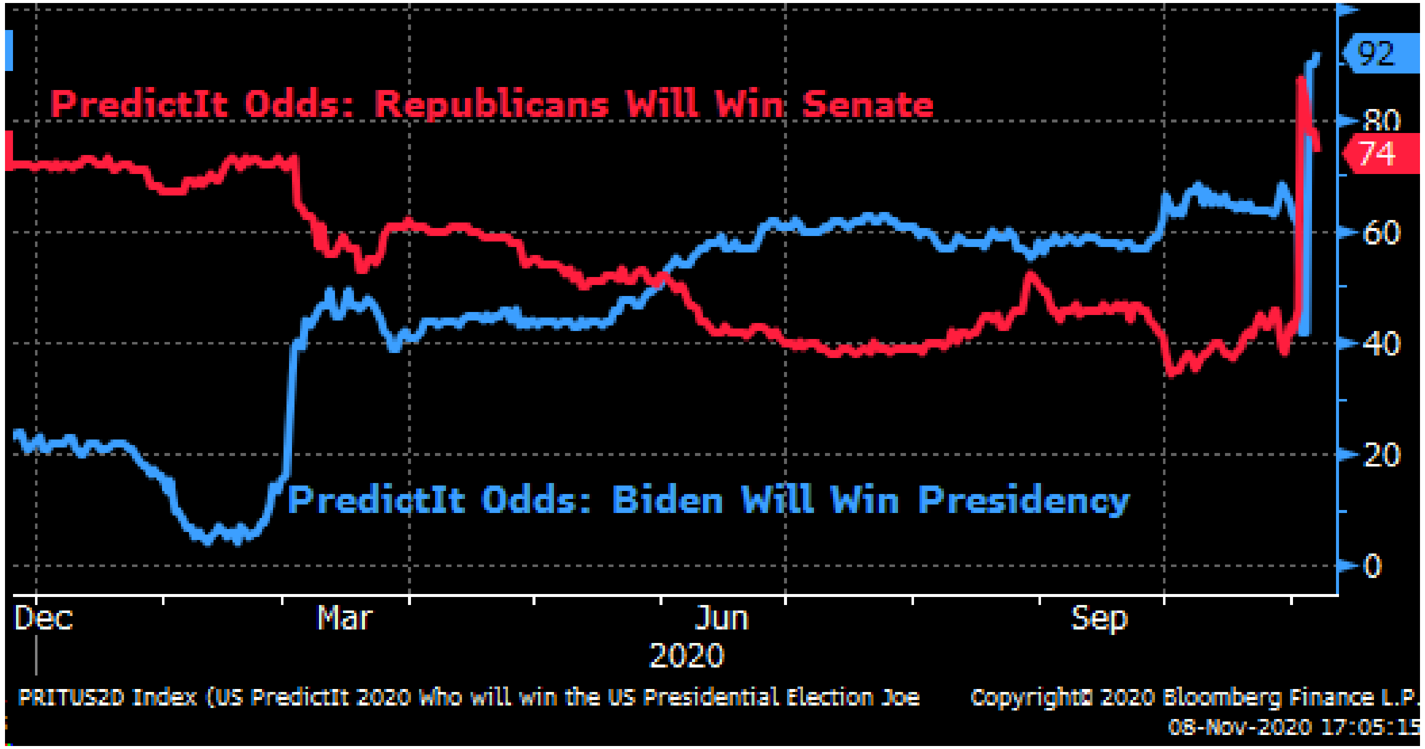
DECISION 2020, THE VACCINE, AND THE IMPACT ON GLOBAL MARKETS

- The 2020 U.S. election results seem to offer a little something for everyone:
- For Democrats, an apparent Biden victory meets the party's primary objective. For Republicans, control of the Senate remains well within reach. Both presidential candidates set records for voter turnout.
- The prize for markets? There were several:
  - Election Day occurred without widespread violence or civil unrest.
  - Policy gridlock appears highly likely.
- Additionally, Monday morning we learned that a vaccine jointly produced by Pfizer and BioNTech has initially proven 90% effective at protecting people from Covid-19 in a study of 44,000 subjects. This is a potential game-changer for the global economy.
- In this document, we will examine what has transpired in 2020 and highlight the known-knowns & known-unknowns that await us in the coming year.

A YEAR IN REVIEW: ELECTION ODDS

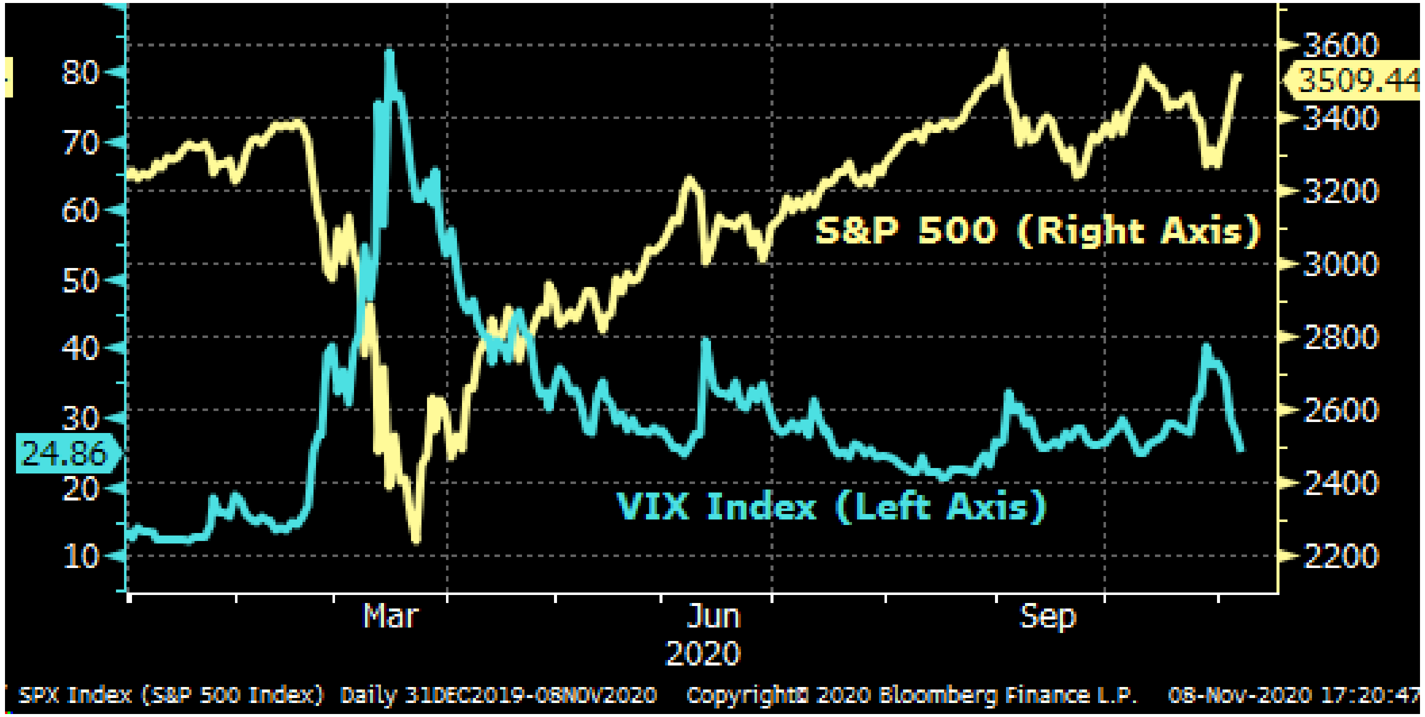
- Biden's election chances steadily climbed over the past 6 months to over 60% for the month preceding the election, so it's safe to say the market expected Biden to win.
- The chances for Republicans to win the Senate inched lower throughout the year as Biden's chances inched higher.
- As of election night, betting markets indicated a ~40% probability of Republicans holding the Senate. Odds have shifted higher now though. The market estimates a ~75% chance that Republicans will win the Senate.

PredictIt Odds of a Biden Presidency & a Republican Senate



CONCERNED, NOT TERRIFIED

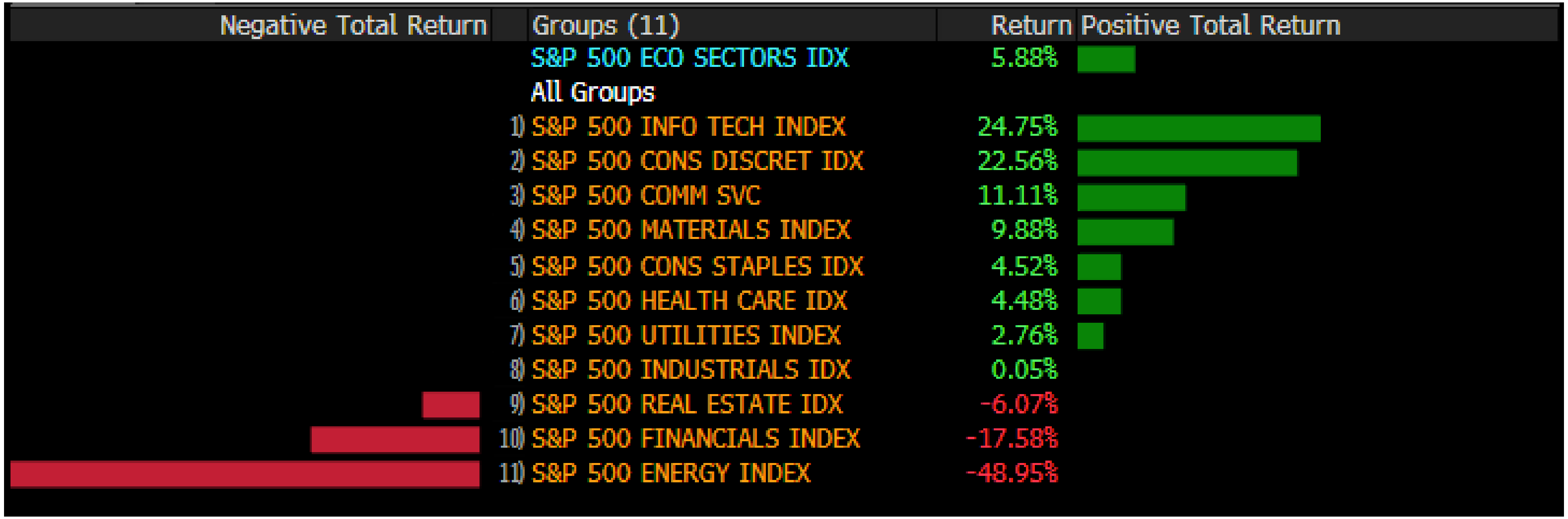
The U.S. Stock Market and Volatility



- We'd describe the market's mood in 2020 as concerned, but not terrified, of the elections.
- As evidence, we'd offer the performance of U.S. stocks, as represented by the S&P 500. Since bottoming in March with arrival of Covid, stocks have steadily marched higher to recoup the ~30% drawdown.
- Additionally, the VIX, which measures stock market volatility, has generally spent most of the past 6 months between 20-30, a level corresponding to heightened concern, but not panic.

PRE-ELECTION THEME IN U.S. STOCKS

- Below is the total return of the S&P 500 by sector, from Jan 1 to Election Day (Nov 3rd).
- Note the big themes: 1) Big tech and consumer discretionary dominate performance at the top; 2) Energy and financials are the big losers; 3) The market was up in the aggregate (+5.9%).



Groups (11)	Return
S&P 500 ECO SECTORS IDX	5.88%
All Groups	
1) S&P 500 INFO TECH INDEX	24.75%
2) S&P 500 CONS DISCRET IDX	22.56%
3) S&P 500 COMM SVC	11.11%
4) S&P 500 MATERIALS INDEX	9.88%
5) S&P 500 CONS STAPLES IDX	4.52%
6) S&P 500 HEALTH CARE IDX	4.48%
7) S&P 500 UTILITIES INDEX	2.76%
8) S&P 500 INDUSTRIALS IDX	0.05%
9) S&P 500 REAL ESTATE IDX	-6.07%
10) S&P 500 FINANCIALS INDEX	-17.58%
11) S&P 500 ENERGY INDEX	-48.95%

Source: Bloomberg

POST-ELECTION THEME IN U.S. STOCKS

- Below is the total return of the S&P 500 by sector, from Election Day to Nov 8th.
- Note that the ranking of sector performance is almost identical to pre-election data, and the market earned almost as much in the past 4 days as it did in the prior 10 months. In other words, the outcome was generally viewed as positive, at least to the extent that it reinforced prior market assumptions.

Negative Total Return	Groups (11)	Return	Positive Total Return
	S&P 500 ECO SECTORS IDX	4.20%	
	All Groups		
	1) S&P 500 INFO TECH INDEX	7.45%	
	2) S&P 500 COMM SVC	6.00%	
	3) S&P 500 CONS DISCRET IDX	4.94%	
	4) S&P 500 HEALTH CARE IDX	4.86%	
	5) S&P 500 MATERIALS INDEX	2.51%	
	6) S&P 500 INDUSTRIALS IDX	1.44%	
	7) S&P 500 CONS STAPLES IDX	1.30%	
	8) S&P 500 FINANCIALS INDEX	0.36%	
	9) S&P 500 REAL ESTATE IDX	0.18%	
	10) S&P 500 UTILITIES INDEX	-0.86%	
	11) S&P 500 ENERGY INDEX	-1.99%	

Source: Bloomberg

TREASURY YIELDS: BEFORE & AFTER THE ELECTIONS

- In the table below, we show changes in interest rates during 2020.
- Yields crashed following the onset of Covid in March as global growth and inflation expectations cratered, while global central banks employed aggressive monetary policy to stimulate the economy. All these actions put downward pressure on Treasury yields.
- Since Election Day, yields have fallen further as investors anticipate smaller stimulus (& thereby less inflation pressure) without the Democrats controlling all three branches of government.

U.S. Treasury Yields

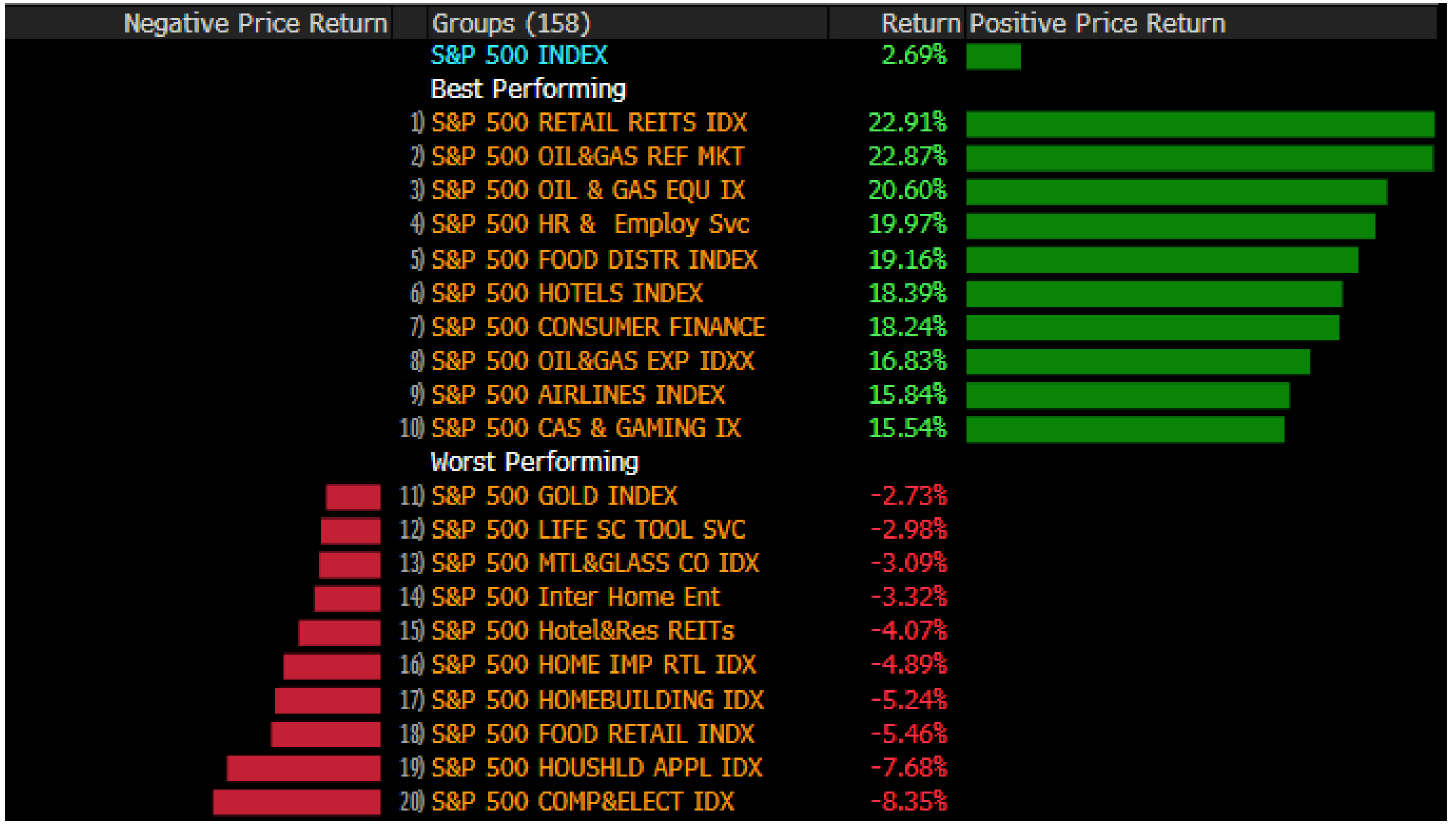
Treasury Maturity	Jan 1st Yields	Election Day Yields	Current Yields	Change from Jan 1st	Change from Election Day
3 Month	1.55%	0.09%	0.09%	-1.46%	-0.01%
6 Month	1.59%	0.11%	0.10%	-1.49%	-0.01%
2 Year	1.57%	0.17%	0.15%	-1.42%	-0.02%
5 Year	1.69%	0.40%	0.36%	-1.33%	-0.04%
7 Year	1.83%	0.66%	0.59%	-1.24%	-0.07%
10 Year	1.92%	0.90%	0.82%	-1.10%	-0.08%
30 Year	2.39%	1.68%	1.61%	-0.79%	-0.08%

Source: Bloomberg, Hamilton Point

VACCINE DAY THEMES

- On Monday Nov 9th, markets received news of an effective Covid-19 vaccine in development.
- Markets reacted strongly. Examine the S&P 500 returns on that day by industry.
- The themes are easy to spot. If (big if) we have access to an effective vaccine, the industries most affected by the lockdowns (retail, travel & leisure, energy) are those expected to benefit the most on the other side of the pandemic, and vice-versa on the "stay at home" trades (technology, home improvement, grocers).

1 Day Price Performance – S&P 500 by Industry



Source: Bloomberg

MORE VACCINE DAY THEMES

- We don’t want to make too much of market “noise,” but news of an effective vaccine is a big development.
- Here are other moves across the market that we found noteworthy on “Vaccine Day.”
- Generally speaking, the theme for that day was rotation – a rotation out of what has worked and into what hasn’t.

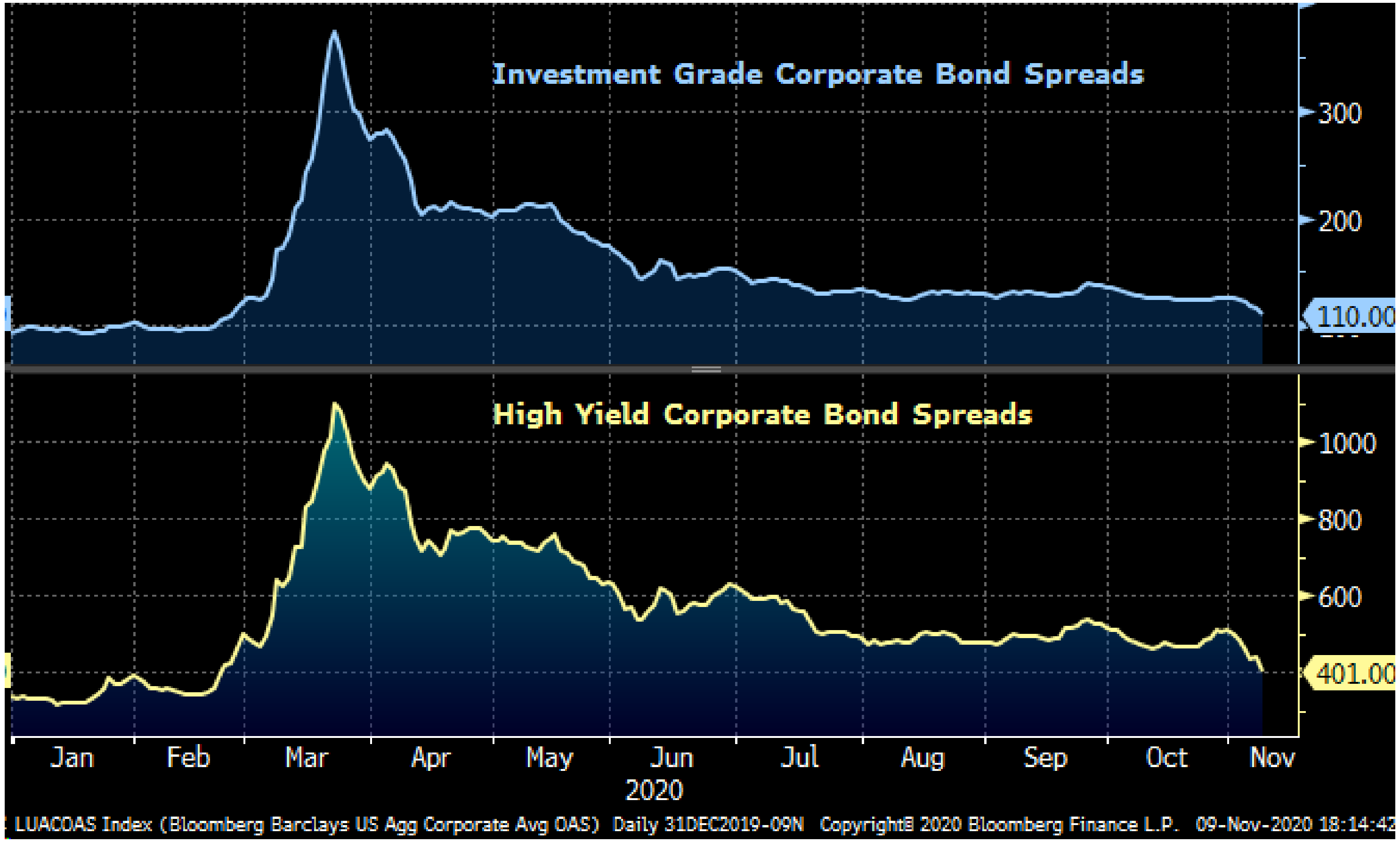
	YTD Change	Vaccine Day Change	
S&P 500	10.3%	1.2%	
Russell 2000	-0.4%	3.7%	Smaller co's reliant on a return to "normal."
Nasdaq	33.7%	-1.5%	Big Tech benefitted from "stay at home" trade & low interest rates.
S&P 500 Value	-8.7%	4.2%	Can value finally outperform growth? Higher interest rates help.
S&P 500 Growth	26.9%	-0.6%	
Euro Stoxx	-9.3%	6.4%	International stocks lagged U.S. all year. Covid driving Europe into lockdowns.
Nikkei	4.7%	2.1%	
Hang Seng	-6.3%	1.2%	

	Price/ Level	Vaccine Day Change	
2yr Treasury	0.15%	+2bps	Near-dated yields barely moved. Fed still on hold.
10yr Treasury	0.82%	+10bps	
2yr-10yr Curve	0.67%	+9bps	Long-dated yields rise & yield curve steepens. Market expects some inflation.
WTI Crude Oil	$37.14	7.3%	Oil rises w/expectations of higher global growth.
Copper	$315.40	-0.7%	
Gold	$1,951.00	-4.5%	Safe-haven trades decline. Perhaps less monetary stimulus globally?
U.S. Dollar Index	92.2	0.6%	

Source: Bloomberg, Hamilton Point

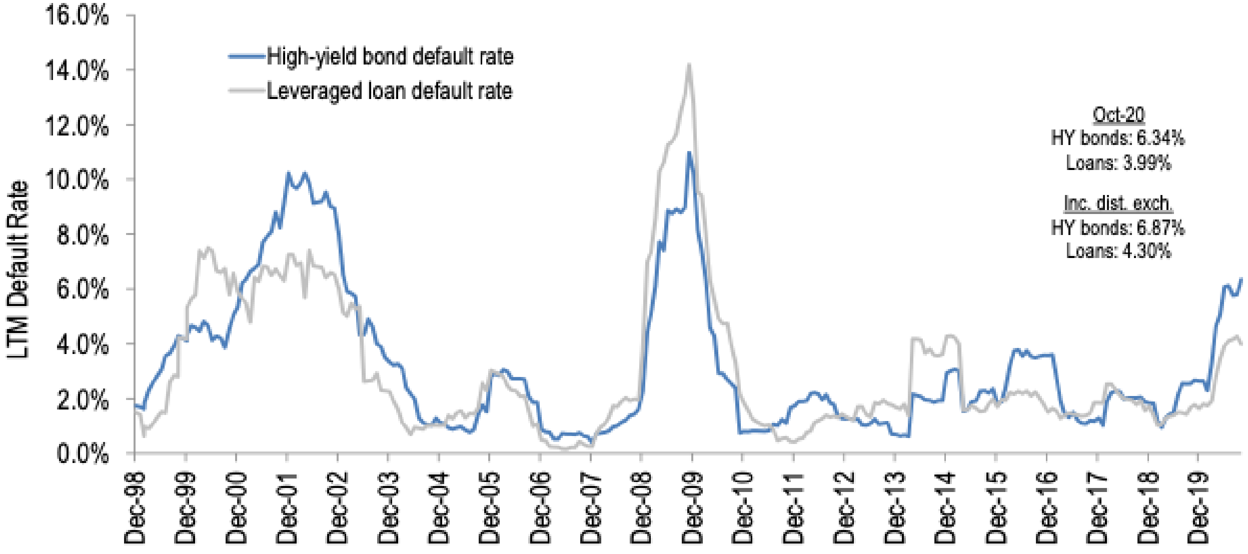
THE MESSAGE FROM THE CREDIT MARKETS

- Despite the difficult operating environment, corporate bond spreads (as shown in basis points) have steadily declined for both high-quality and low-quality companies since March.
- Without question, the Fed's aggressive intervention in the spring was the key factor in stabilizing the credit markets.
- In addition, historically low Treasury yields have compelled investors to take credit risk in an attempt to increase yield in their portfolios.

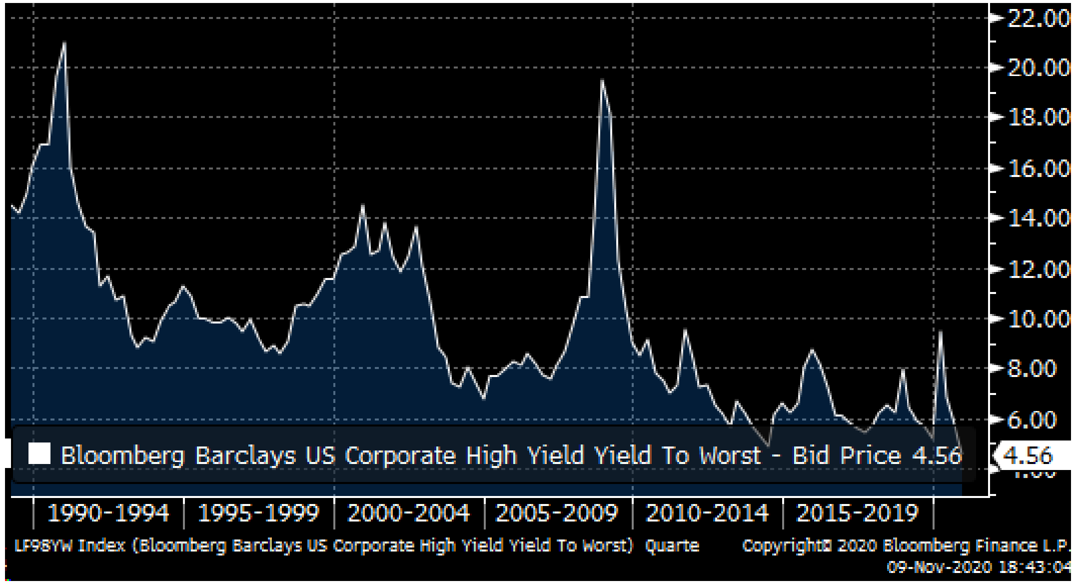


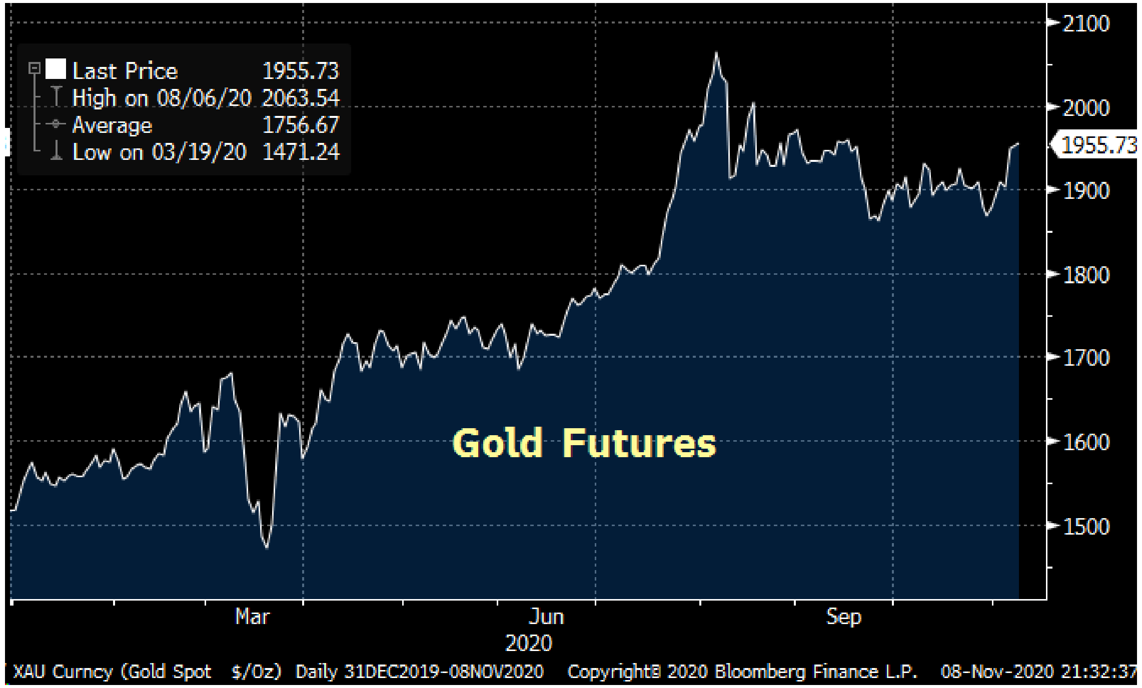
THE REACH FOR YIELD

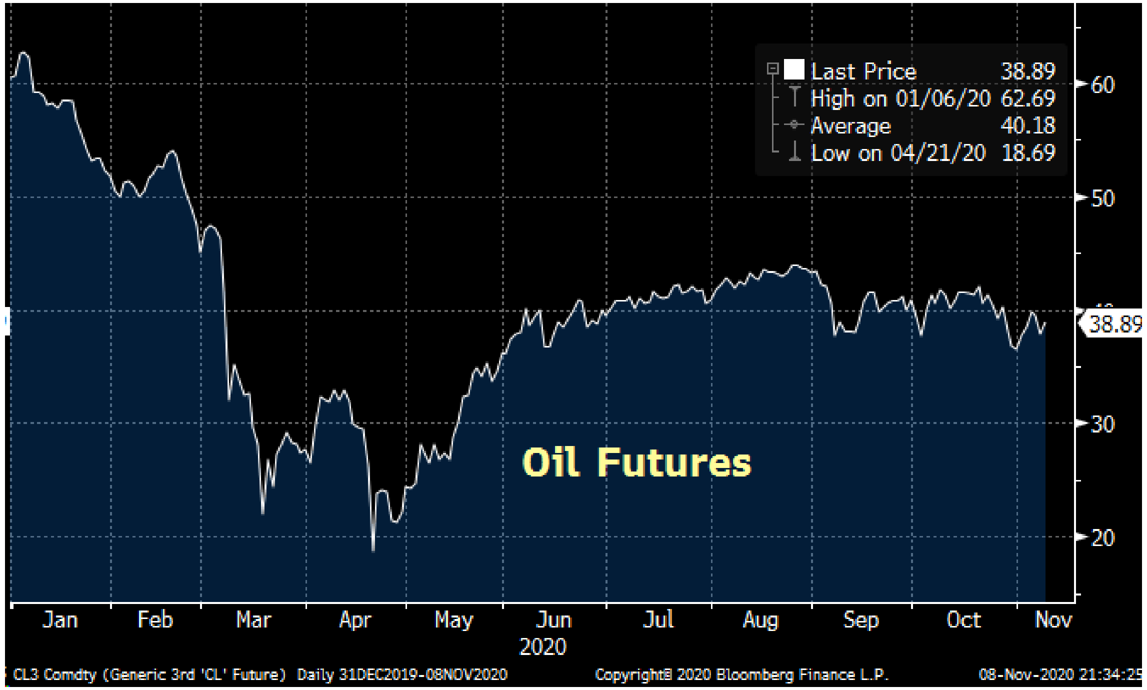
- As interest rates decline, investors often reach for yield.
- As we noted in our last newsletter – Candidate TINA (There Is No Alternative) – investors must make tough decisions when safe investments such as savings accounts, treasury bonds and muni bonds yield close to zero.
- We believe the appetite for yield, coupled with an optimistic view on the future economic environment, has pushed many investors into high yield bonds.
- Despite rising (and relatively high) defaults, investors have pushed the yield on the High Yield Index to an all-time low of 4.56%.



Source: J.P. Morgan.







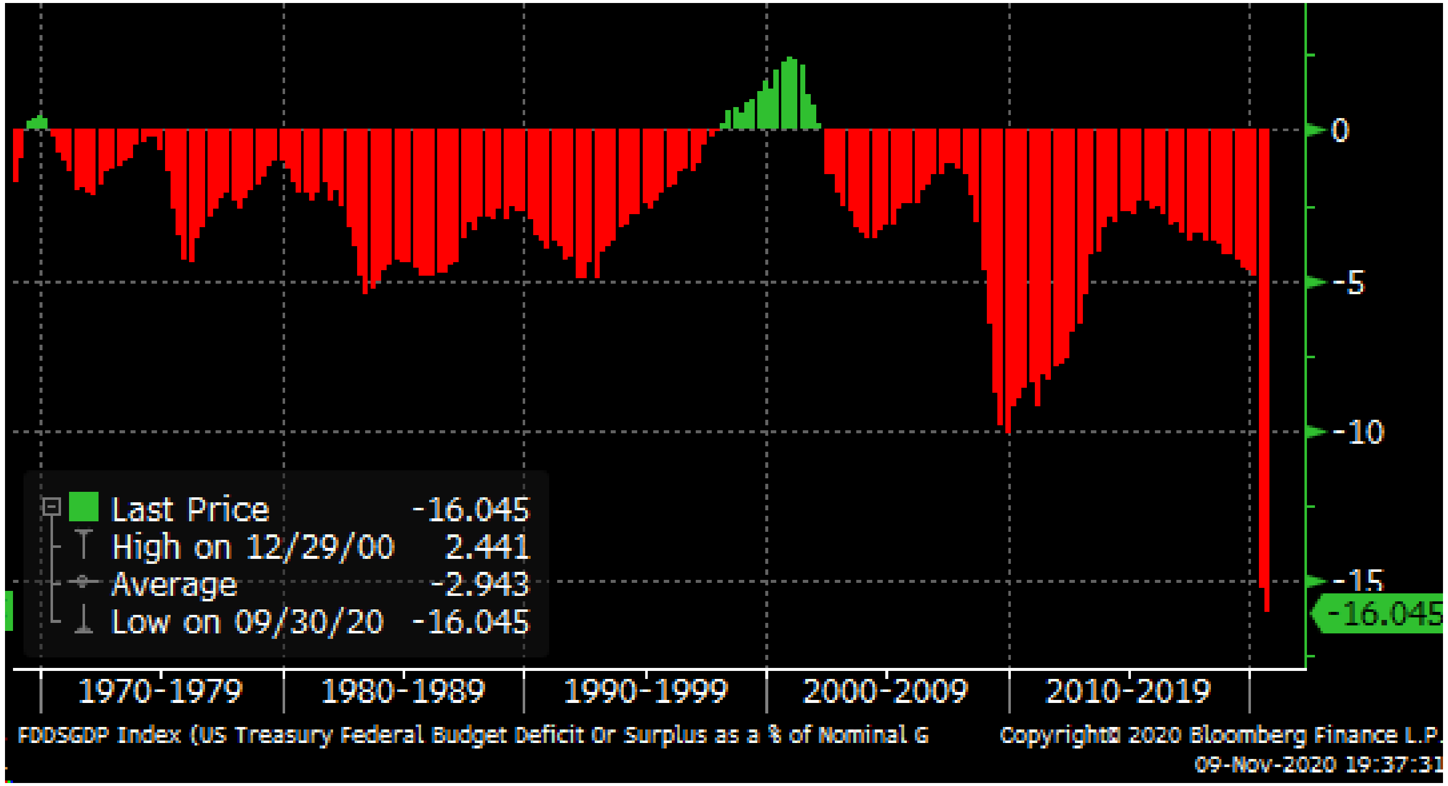
A CLOSER LOOK AT COMMODITY MARKETS

- Gold remains higher on the year as investors worry global central banks are devaluing money
- Oil continues to suffer from supply/demand imbalances
- Looking for a bullish signal? Copper prices, which are a leading indicator of global GDP, have been climbing

LOOKING AHEAD: BIG DEFICITS

- Budget deficits were rising at a rapid clip after the 2017 tax cuts.
- Then Covid-19 hit. Tax receipts dropped while government spending jumped. Now the U.S. budget deficit over the last 12 months has climbed to an unprecedented 16% of GDP.
- Large deficits will force government, at all levels, to make difficult spending decisions for years to come.
- Theoretically, these deficits should provide upward pressure on interest rates. Practically speaking, we have yet to observe that dynamic despite large deficits since the Financial Crisis.

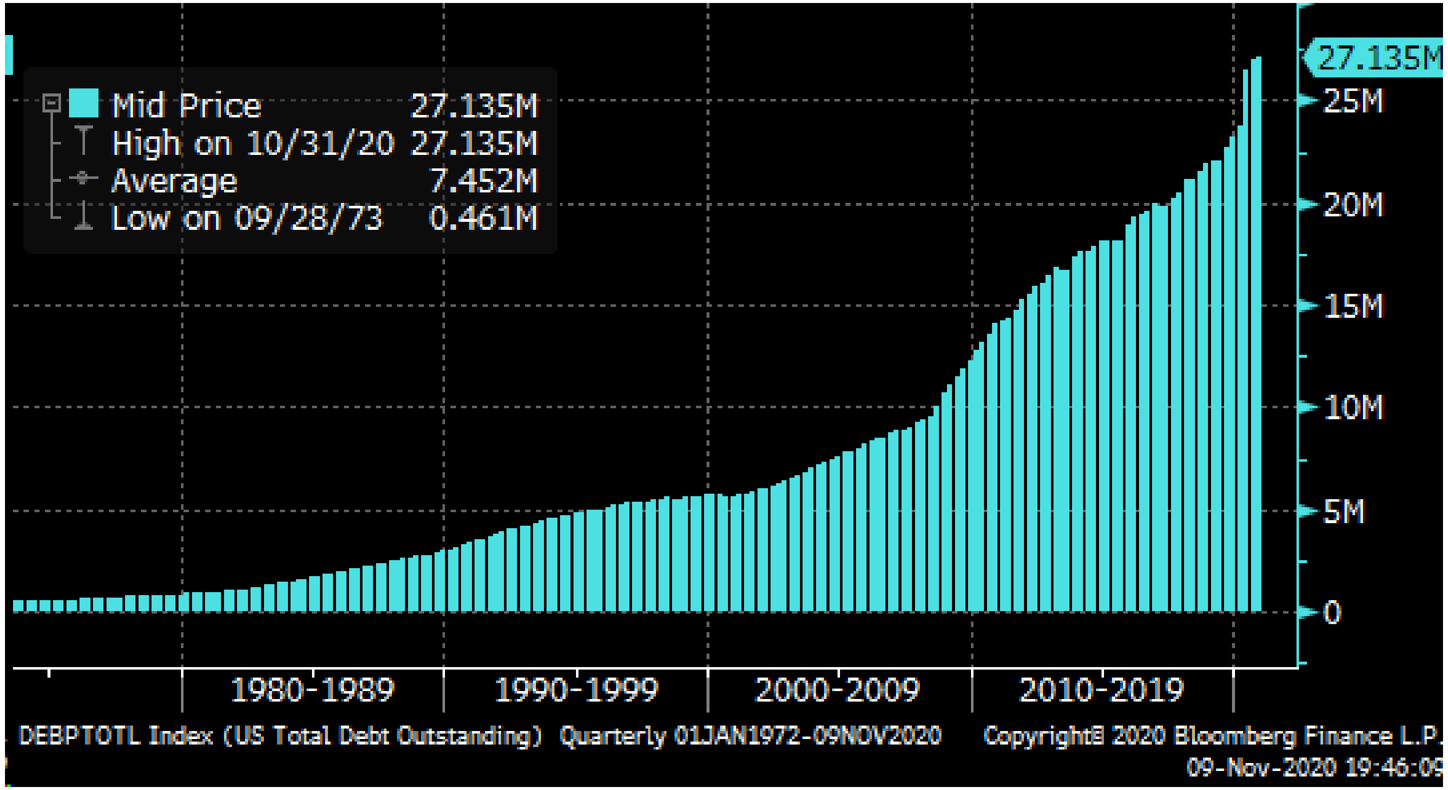
U.S. Annual Budget Deficit/Surplus (as a % of GDP)



LOOKING AHEAD: THE NATIONAL DEBT

- The U.S National Debt has roughly doubled in every decade since the 1970s. This persistent compounding has resulted in a large debt balance for the country.
- Here again, the pandemic has taken its toll. The national debt was $23.2T at the start of 2020 and will eclipse $28T by the end of the year.

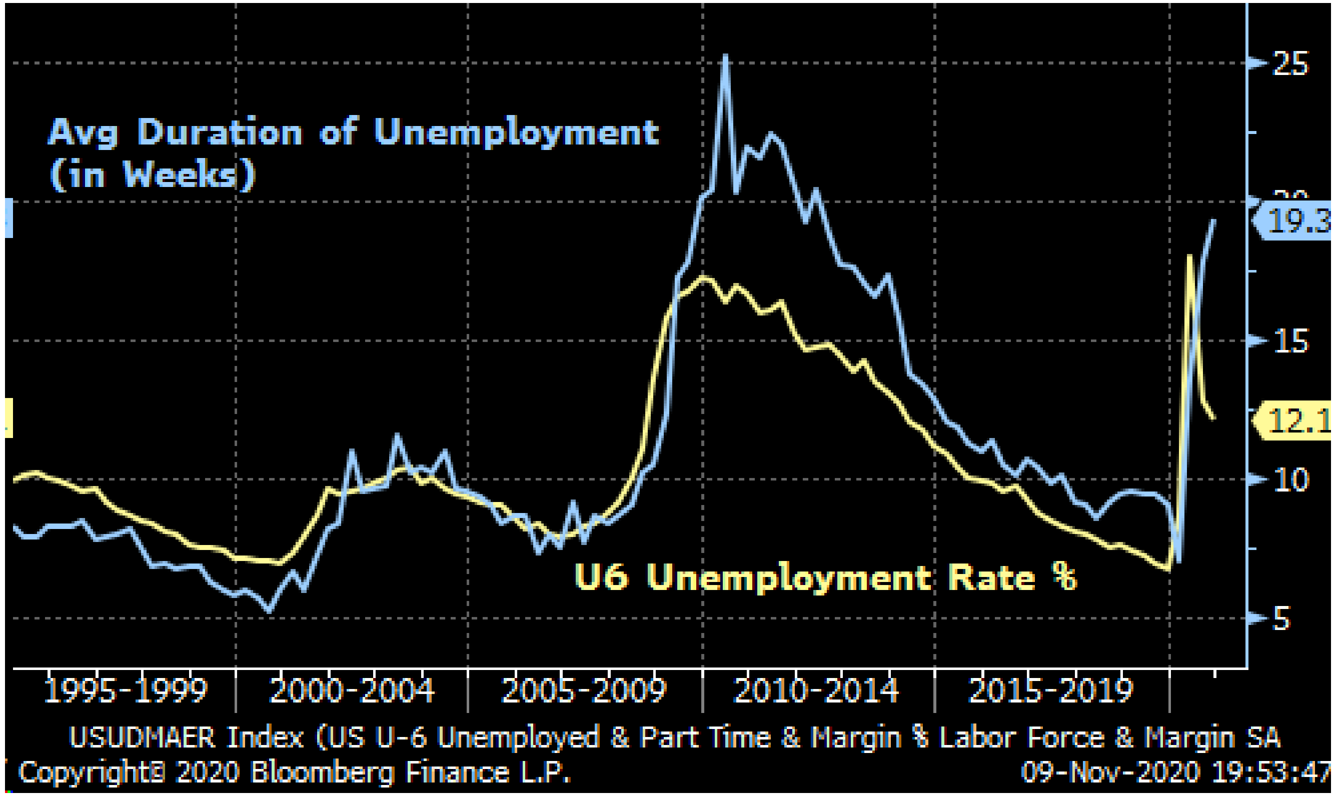
U.S. Total Debt Outstanding ($ Trillions)



LOOKING AHEAD: UNEMPLOYMENT

- Though the official unemployment rate (referred to as U3) is 6.9%, we believe it's informative to look at the U6 rate, which includes the unemployed, as well as those who are working part-time but are seeking full-time work. As of October, the U6 rate was 12.1%.
- Equally troubling is the average duration of unemployment, which has jumped to 19 weeks. Longer unemployment leads to a loss of skills and a higher risk of being permanently unemployed.
- More stimulus and a vaccine will likely be required to quickly return these individuals to the work force if we want to avoid the prolonged labor market recovery observed after the Financial Crisis.

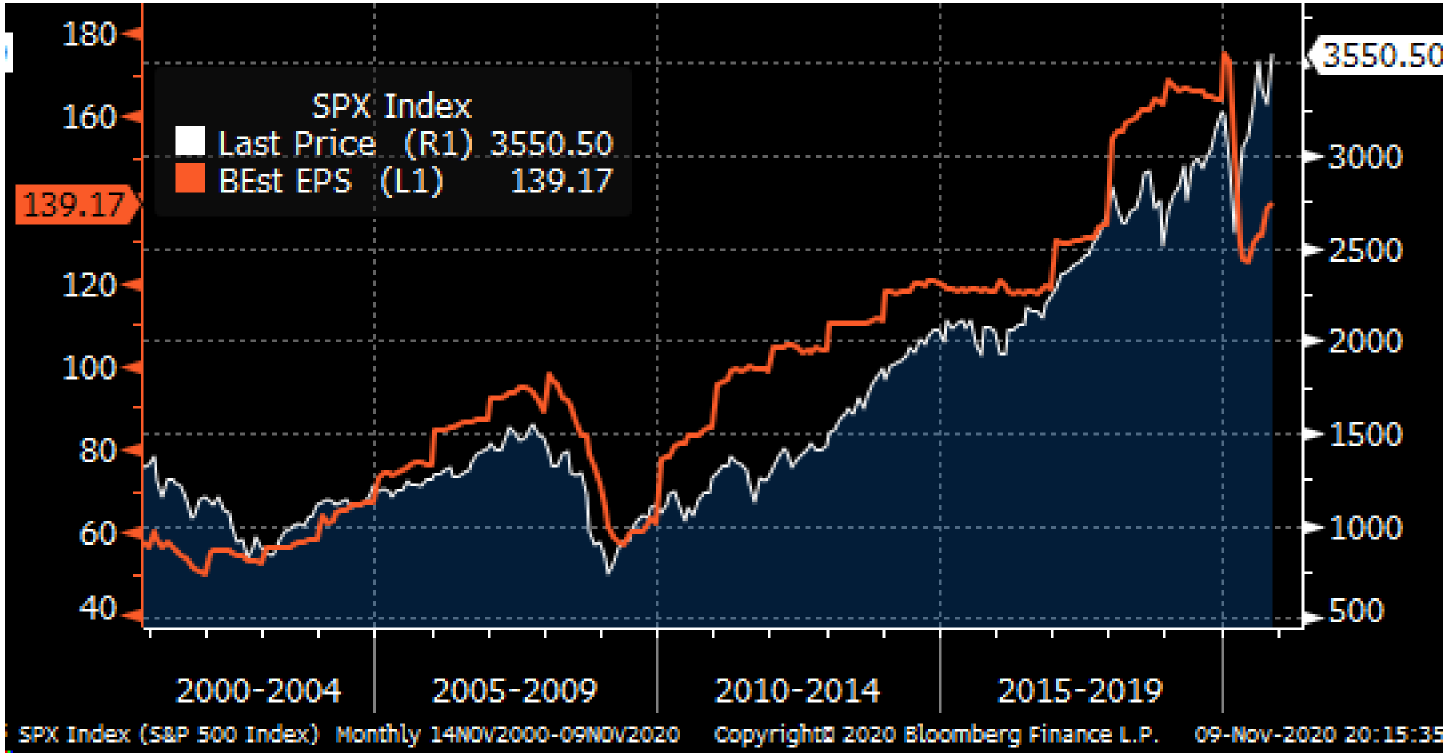
The Unemployment Rate (U6) & Average Duration of Unemployment



LOOKING AHEAD: CORPORATE PROFITS

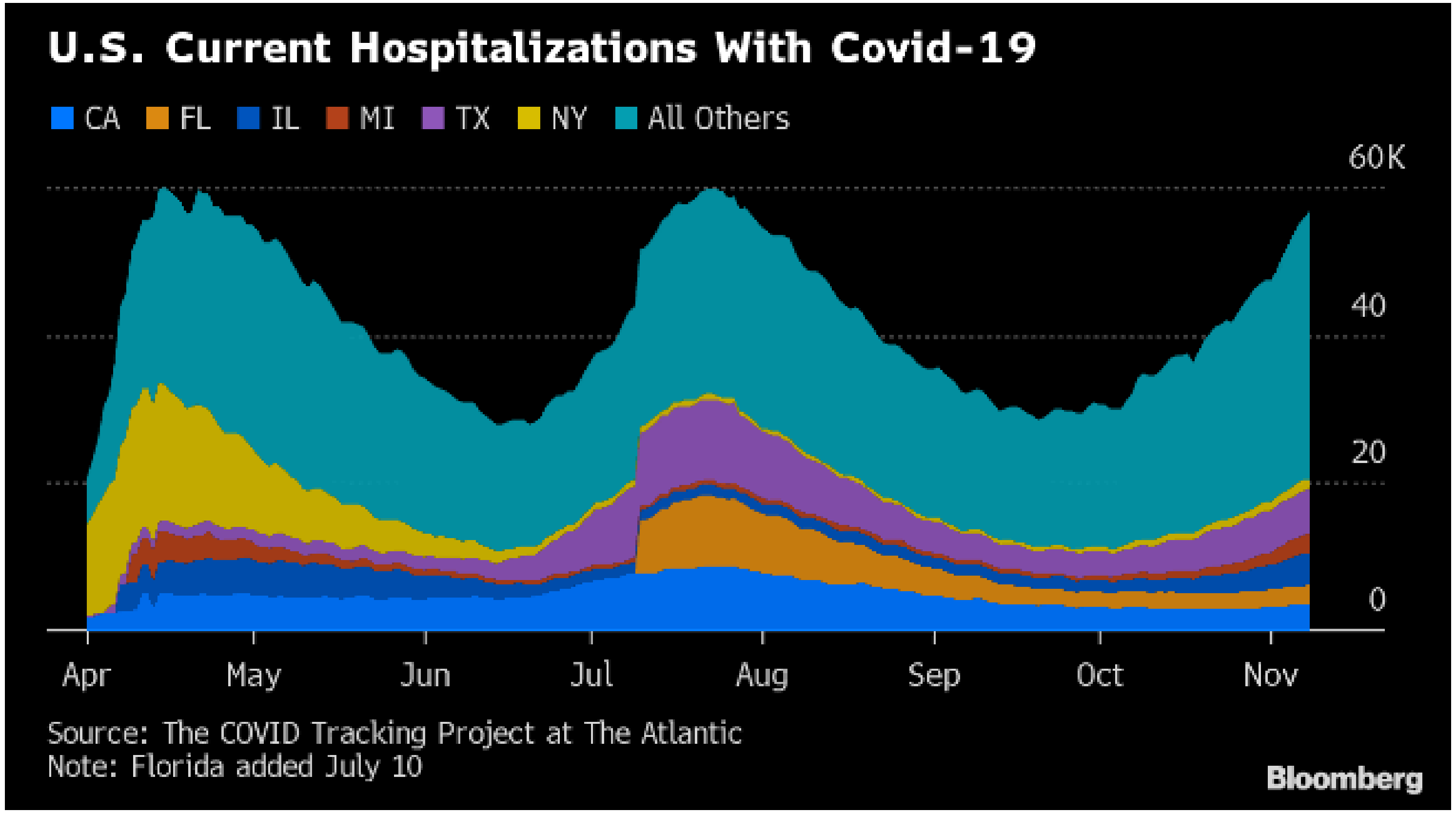
- Historically, there's a tight correlation between corporate profits (measured here through earnings per share – left axis) and the performance of stocks (S&P 500 index – right axis).
- 2020 has been an extraordinary year in the markets in many ways. This year's stock rally is just one example of that uniqueness. As shown, there has been a decoupling between the stock prices and profits for the first time in 20 years.
- The market is pricing in a sharp rebound in profits in 2021 (estimates are $167 in EPS). Should that profit resurgence not materialize, stocks could trade down.

The S&P 500 & Earnings per Share



LOOKING AHEAD: THE THIRD COVID WAVE

- As Europe grapples with its second wave of Covid-19, the U.S. is experiencing its third as it heads into what public health experts describe as a "dark winter."
- Whatever your view on tests and cases, hospitalizations is one piece of evidence of the toll the virus takes on society.
- Even with more Americans growing fatigued of the virus, we believe numbers like these are likely to push more individuals into a "lockdown" mode in the weeks to come – whether that be self-enforced or mandatory. That behavior will slow the economic recovery until the wave once again crests and begins to fall.



OUR EXPECTATIONS OF WHAT'S TO COME

- "Gridlock is Good"
  - The market sees some advantages to a Biden presidency with a Republican senate:
    - Biden will be limited in his ability to execute any progressive legislation, such as repealing the 2017 tax cuts or enacting major changes in energy policy.
    - Gridlock likely means a lower stimulus package and therefore a slower economic recovery. While a headwind to short-term growth prospects, this lowers the risk of a sharp jump in interest rates.
    - Biden is generally perceived as likely to lower geopolitical risk and encourage more trade (removal of tariffs).
  - The market believes it is likely we have a clear winner. While there is still disagreement and some legal challenges are ongoing, it appears unlikely to markets that enough of them will be successful in invalidating the apparent result. Much like humans, the market can deal with just about any scenario once it knows the outcome, but uncertainty often leads to a great deal of suffering.

OUR EXPECTATIONS OF WHAT'S TO COME

- **"Recoveries Take Time"**
  - As much as we'd like a quick return to normal, history tells us that it takes a frustratingly long time to recover from an economic shock. We expect that it will be years before we reach "normal" levels of employment and economic growth. That being said, corporations have had a knack for becoming more efficient during each of these shocks, so it would not be surprising for corporate profits and the world's stock indices to recover quite quickly.
- **"The Fed Will Remain Supportive"**
  - The Federal Reserve has repeatedly emphasized their employment mandate, even if it causes temporary disruptions to price stability. As noted above, we expect that the Fed will have an uphill battle to fight in restoring the U.S. to full-employment, particularly if government support is limited. If the Fed continues to keep rates low, we believe investors will have a strong wind at their backs.

OUR EXPECTATIONS OF WHAT'S TO COME

- "Asymmetric risk in bonds"
  - We aren't sure that interest rates will go higher, but we are sure that investors aren't being well-compensated to bet against it. Consequently, you'll notice that the vast majority of our fixed income exposure is in short duration (which has less exposure to higher interest rates) and high-quality bonds (which are less exposed to a deteriorating economic environment).
- "Save the risk budget for stocks"
  - One reason that we're taking a highly cautious approach in fixed income is that we'd rather take risk in high quality stocks. Though stock valuations are not cheap, solid investment opportunities remain in companies that have proven the ability to grow, despite the pandemic.

OUR EXPECTATIONS OF WHAT'S TO COME

- "Change is in the Air"
  - The elections, the third Covid wave and the vaccine(s) will all have repercussions for the markets. We believe that these repercussions are likely to flip some of the themes that have dominated markets recently. More specifically, we believe small companies may be poised to outperform next year due to an improving economic environment, and that international and emerging markets will look attractive based on valuations and an improved global trade environment.

ABOUT THE AUTHOR

K.C. Nelson
CHIEF INVESTMENT OFFICER
knelson@hamiltonpoint.com

As Chief Investment Officer and head of the Investment Committee, Mr. Nelson focuses on monitoring current market conditions and optimizing the firm's investments to achieve long-term results for the firm's clients. Over the course of his career, Mr. Nelson has built and managed multi-billion dollar funds that focus on fixed income and event driven strategies. His views on the markets have been regularly reflected on CNBC, Bloomberg, the Wall Street Journal and the Financial Times.

hamiltonpoint.com

@hamiltonpoint

Hamilton Point Investment Advisors

Contact

T:(919) 636-3765

100 Europa Drive, Suite 425
Chapel Hill, NC 27517

DISCLOSURE

The opinions expressed are those of Hamilton Point Investment Advisors. The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Forward looking statements cannot be guaranteed. Material presented has been derived from sources considered to be reliable, but the accuracy and completeness cannot be guaranteed.

Hamilton Point Investment Advisors is an investment adviser registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training. More information about Hamilton Point's investment advisory services can be found in its Form ADV Part 2, which is available upon request. HP-20-267