Directions

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CLS INVESTMENTS

Stock Market Outlook: The Best Time of Year

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What a month. What a year. While 2020 has been a year of incredible anxiety and fear in nearly all aspects of life, it has been good for the financial markets and disciplined long-term investors. These good tidings are more likely to continue than not.

Let's first review some of the past month's highlights. The three weeks after the election marked the second-best post-election stock market returns since Ronald Reagan's election in 1980.[1] It was the best month in decades for small-caps. Multiple indices hit new all-time highs.

Also notable was the Dow Jones Industrial Average cleared 30,000 for the first time ever. It may be surprising that I am even mentioning the Dow Jones. It's a terrible index to follow, most importantly because it is simply not representative of the overall market or economy. Nonetheless, it is the index that the major media has focused on for many years.

I believe the Dow's historic ascent brings up an important illustrative point. Consider this. The Dow had never cleared 15,000 before the Great Recession (global financial crisis) of 2008-2009 and the Great Reset from COVID-19 (history will determine the best name). These are two of the ugliest periods in U.S. stock market history — and they happened within the last 12 years. The Dow Jones is now more than double the price pre-Great Recession.[2] Before the dot-com bust 20 years ago, the Dow had only cleared 11,000. So, factoring in three of the greatest and scariest bear markets, the market is nearly 3x higher. And this is only looking at price return. Total return includes income from dividends. During this time, the Dow Jones also had a dividend yield of 2-3% per year, give or take. The lesson is the market's tendency to move higher over time is powerful. However, the cost of investing is gut-wrenching price volatility.

What to expect moving forward? As always, the grab bag of factors is mixed, but I believe the near-term outlook favors more gains.

We are still in the best time of year for stock market gains. The December and January stretch has historically been the strongest two month period for stock market returns, both in terms of average gain and probability of gains.[3] There are calendar effects at play that seem to drive this market behavior, including holiday spending, tax planning, and year-end bonuses.

1 Yahoo Finance 11/2020
2 The Balance 4/2020
3 BBC 12/2018

Bigger picture: The drivers of market returns in recent months remain steadfast. These include massive support from monetary and fiscal policy ("Don't Fight the Fed"), positive market movement ("Don't Fight the Tape"), and economic improvement ("Things Are Getting Better"). All three drivers may be accelerating thanks to potential new fiscal stimulus, better breadth in the market, and positive vaccine news.

There are headwinds, of course, like there always are. The significant rise in COVID-19 cases will temporarily slow the economy. Nonetheless, spring will eventually arrive. According to Ned Davis Research, current data suggests the economic slowdown will likely be temporary.[4] In addition, the incoming Biden administration will most likely stimulate the economy further, a vaccine(s) is on the way, and the weakness in the U.S. dollar should help exports and, thus, the economy.

Another factor to consider is the "Wall of Worry." This has been a positive for the market, but at this point it is not. While I am still having conversations with many people who remain worried about the market, their stories have become anecdotes. The aggregate sentiment data is showing outright enthusiasm. While this indication is typically a near-term plus for investment flows into the markets, from a forecasting perspective it tends to be a contrarian negative signal. In other words, when investors get extremely bullish, and this can be measured by what they are saying (sentiment surveys) and doing (investment flows analysis) as well as as implied volatility or short interest, the market tends to produce below-average returns (albeit positive) in the following months.

4 Ned Davis Research 11/2020

Rising Rates, Rising Concerns?

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Over the summer the yield curve quietly began to steepen, and over the past few weeks that trend has accelerated. First, the expectation of a blue wave and mass fiscal stimulus prior to the election caused rates to rise. While neither happened, the combination of some level of further fiscal stimulus, the potential for inflation given explosive economic growth off the COVID recession lows, and overall high levels of liquidity throughout financial markets, is leading to higher U.S. Treasury yields.

This may be concerning to investors in fixed-income vehicles, as higher rates generally lead to losses in bond prices due to their inverse relationship. It's a reasonable concern, but historical data shows long-term investors should likely not be too concerned. The CLS white paper "Bonds in a Rising-Rate Environment" explains that bond performance may trail in the short term, but in the long term it is similar, if not better, than historical performance as rates rise.

How can this be? Price losses can be offset by reinvesting coupons at the higher rate and garnering higher returns over the long term.

INTERMEDIATE-TERM TREASURY BOND ROLLING RETURNS (BASELINE)						
	3MO. ROLLING RETURN	6MO. ROLLING RETURN	1YR. ROLLING RETURN	3YR. ROLLING RETURN (ANNUALIZED)	5YR. ROLLING RETURN (ANNUALIZED)	10YR. ROLLING RETURN (ANNUALIZED)
Period Count	657	654	648	624	600	540
Average Return	1.7%	3.4%	6.9%	6.9%	7.1%	7.4%
Positive Return Frequency	76.1%	82.0%	91.4%	100.0%	100.0%	100.0%

Returns based on IA SBBI Intermediate Term Treasury Bond Index from 1/1/1962 - 12/31/2016

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Yields are based on the yielf to maturity of the on the run 5-Year Treasury Bond Index from 1/1/1962 - 12/31/2016

1 *CLS White Paper*

Higher rates, and specifically a steeper curve, can be a tailwind for financial stocks. The 10-2 year Treasury curve spread has broken out to multi-year highs, as shown in the chart below, giving some much-needed support to financial stocks that have lagged the broad market for several years. Since the most recent low at the start of July, financials have outperformed the S&P 500 by 5%, supporting the theory that an increase in curve steepness may lead to financial outperformance.

Source: Bloomberg 11/23/20

Higher bond yields may help support their investment case, not only for the prospect of better income and higher expected returns, but as effective diversifiers to high-risk assets. As proponents of Risk Budgeting, we believe having multi-asset portfolios is essential to properly targeting risk. Having several quality tools in our arsenal to accomplish this goal only enhances portfolios.

We believe the current environment remains favorable for businesses and consumers alike. Although rates may be rising, it still remains a historically low interest rate environment, which allows creditors to borrow at low rates and service existing debt. This helps to facilitate business investment and consumer spending without threatening the overall credit environment.

In summary, although higher rates may hurt fixed-income returns in the short term, the long-term impacts may be mostly positive for several areas of the market. The near term may be volatile, so stay the course and trust the investment principles put in place to achieve your long-term investment goals.

More Reasons to **Go Global, Now**

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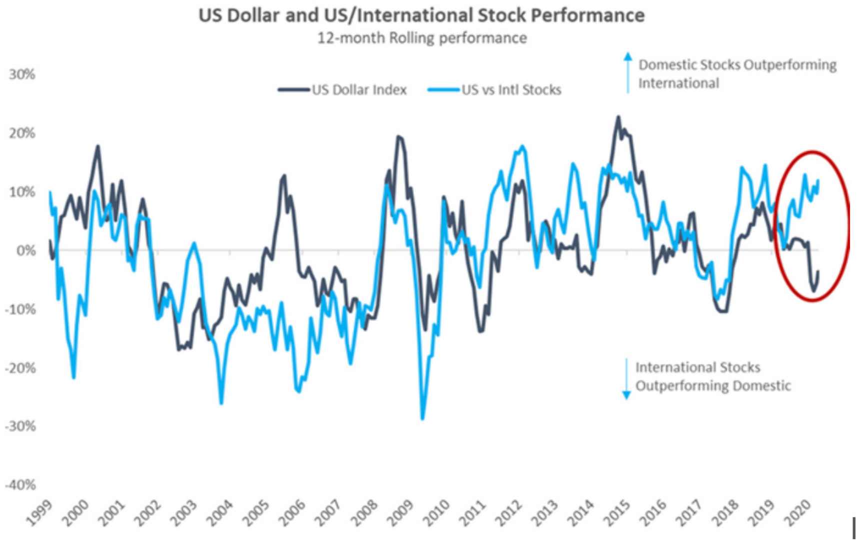
We have long been advocates of global investing. While the case for international stocks hasn't been very clear in recent years due to the surge in U.S. growth stocks, there is always a strong argument to be made for a global portfolio. Though there are a number of long-term reasons, I want to highlight a few of the intermediate-term reasons to consider a more global approach.

The Dollar

First, the U.S. dollar, which had been stubbornly strong since early 2018, has taken a breather from March highs. All else being equal, this may significantly benefit international stocks. For a U.S.-based investor, a weaker dollar typically causes foreign stocks priced in foreign currencies to increase in value. As you can see in the chart below, international stocks have typically outperformed during a weak dollar environment and vice versa (with a correlation of 0.6). So far this year there has been a disconnect; however, as the chart shows, these disconnects don't tend to last forever.



Sources: CLS Investments, Bloomberg, Morningstar Oct. 15, 2020

On top of this, as we've written and talked about before, the potential for inflationary pressure is high, which tends to weigh on the dollar. Interest rate differentials are also not favorable for the dollar going forward. If we continue to see dollar weakness, international stocks could be beneficiaries.

China

China's gross domestic product is the largest in the world, adjusted for purchasing power parity, and is not far behind the U.S.'s on a nominal basis. However, the market capitalization of Chinese stocks is less than one-third of ours. China's economy is rapidly recovering, and so is its stock market. China also has its own version of our FAANG (or any number of other acronyms) stocks, known as BAT, which stands for Baidu, Alibaba, and Tencent. I actually prefer JAT or TAJ, which includes JD.com, Alibaba, and Tencent, three Chinese internet companies that have soared by an average of 70% this year.[1] China is becoming a larger and larger part of international indices, particularly in those specific to emerging markets. China's massive demand affects the entire global economy, but arguably the best way to participate is to own international shares.

Sources: Morningstar, MSCI, October 16, 2020

Potential Tax Changes

You may not know this, but there is an election coming up. I always caveat that I do not want to get political here or recommend stocks based on election potential (as I wrote about [here](#)). Presidential candidate Joe Biden has made it clear that he wants to raise corporate taxes, from roughly 20% to 28%[2]. This may potentially be enough for some companies to move back overseas, at least for their headquarter locations. But, more importantly, it could also potentially cause overseas profits to be relatively more attractive. Even if tax rates are still higher overseas, an adjustment in after-tax U.S. profits, without a subsequent adjustment in overseas profits, may adjust the value proposition for international stocks.

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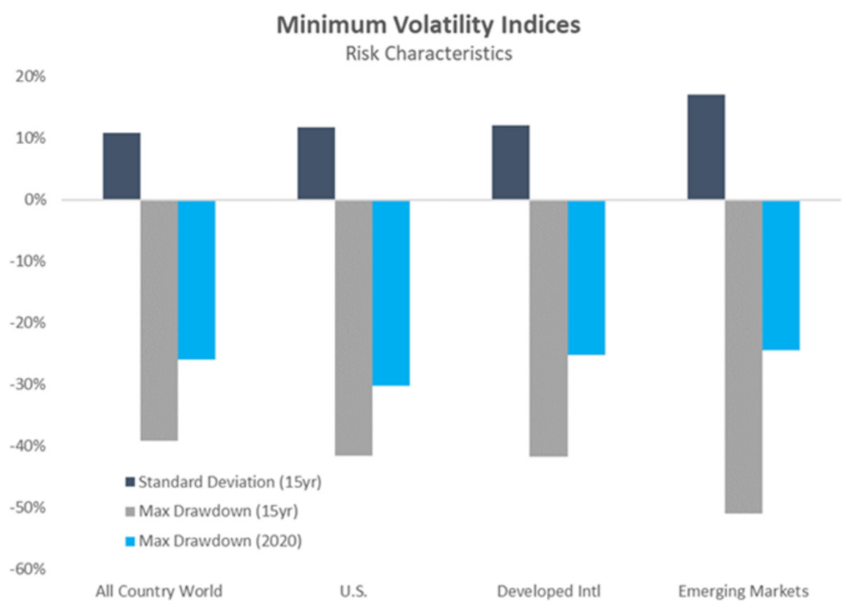
1 Source: Bloomberg 10/16/2020, International Monetrary Fund 2019.
2 Source: The Wall Street Journal 10/21/2020
https://www.wsj.com/articles/how-joe-bidens-tax-plan-could-affect-you-11603307433

Opportunity Set

A broader opportunity set overseas is a potential long-term benefit of global investing; however, we also tend to see examples of this benefit play out in some fashion each year. Despite the aforementioned disconnect between a weak dollar and lagging international stocks, several global ETFs have outperformed the domestic market this year. In fact, more than 100 equity ETFs with more than 45% international stocks have outperformed the S&P 500 this year (excluding levered and inverse strategies).[3] On top of this, international stocks may provide risk reduction and diversification benefits that are often overlooked. One of the best ways to look at this is illustrated below. Minimum-volatility indices are designed to “optimize” for the lowest risk portfolio possible, within a certain set of parameters. Through almost every observed time frame, the global index, which includes U.S., developed international, and emerging market stocks, has demonstrated the lowest risk (shown here as standard deviation and max drawdown). This year, all of the indexes listed below fell less than the U.S. version.



Sources: Morningstar, MSCI 10/16/2020

We believe a global, flexible, risk-managed portfolio is well-suited to take advantage of opportunities abroad. U.S. stock market dominance is getting more stretched by the day. Diversifying overseas not only helps to reduce that risk but may also increase opportunities in more attractively valued markets suited for potential future outperformance.

3 *Source: Morningstar Direct, 10/16/2020*

Disclosures:

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