CONWAY• JARVIS LLC
Investment Outlook

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Update

Tailwinds for the Market: Low Expectations and the Fed

Last week, we saw anecdotal evidence of a second wave of the virus spread throw fear into the market to the tune of an almost 6% sell-off in the major averages. This week, the S&P 500 has clawed back a good portion of that decline on the wings of a well-received Retail Sales report and a better-than-expected Empire State Mfg. survey. Both exceeded analysts' modest expectations formed in the aftermath of April where the economy ground to a halt as the result of the lockdown.

The market's reaction to the dismal employment report of two weeks ago was the first indication that traders would reward economic data, however disappointing, if viewed as a positive surprise in light of the estimates. They apparently took the view that 13% unemployment could have been worse, considering expectations, and piled into equities. It appears economic data that would normally be seen as negative by investors is rewarded by the market if it simply falls short of the dire estimates in place. That's a low bar for stocks to hurdle and, with an assist from the Fed's Jetstream of stimulus at its back, could explain the market's current resilience during the onset of a recession.

We're now seeing a trend emerge that could define a trading range for the market around its 200-day moving average. In the past month we've seen any data-inspired advance in stock prices quickly undone by headlines regarding a second wave of the virus spread. It seems that investors with short investment horizons are forced to take the longer view when confronted by the persistence of the virus and the possibility of a slow, uneven recovery from the cold winter of recession.

Not surprisingly, bearish investor sentiment currently resides near a record high. That's a contra-indicator with near-term bullish implications. Couple that with a record $4.6 trillion in cash on the sidelines in money markets and a scarcity of viable investment alternatives to equities and you have conditions that are ripe for a major market advance just like the one we've had. Will we have another leg up from here? Hard to say, given the rich forward-looking valuation of the major averages. Could it happen? Of course, since it's long been established that you can't fight the Fed when they're stomping on the accelerator. The result could be the creation of an asset bubble in equities similar to that of '99. We'd view that as reason to lower exposure to stocks rather than chase the market.

As of now, we think it prudent to straddle the fence: we're sufficiently invested and have cash on hand. The second half of an election year should bring an awakening to the reality that a longer-than-expected recovery is ahead. We remain in the camp of long-term investors awaiting the opportunities that will appear in a consolidation of what we believe to be a bear market rally.

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