Q3 Newsletter: Overview of Q2

The second quarter of 2020 will long be remembered for its volatility, and the precipitous drops in the market. However, by the end of June the market started to show signs of resilience, and the weight of the evidence suggests the current market rally may persist.

The Fed’s aggressive stimulus measures, along with that of other central banks are having the desired effect of reducing risk premiums, (the return above the risk-free amount a stock is expected to yield). By the end of the quarter, the “reflation trade,” was showing promising sides. Reflation refers to a market that starts trending up after a long period of no inflation. The reflation trade involving the most economically sensitive assets confirms that the central banks’ actions are working.

If you have been watching John’s weekly videos, you know that the most powerful part of technical analysis is that it removes your emotions from the equation and helps you understand what the market is saying. Technical analysis separates what SHOULD happen based on fundamental projections from what IS happening. Currently, the market is loudly saying the Fed’s massive infusion of cash into the economy worked to turn the tide, and risk assets are going higher. However, even with the $2 trillion governmental stimulus package, market volatility is still to be expected. At JCN, your assets are protected because every stock has a stop loss amount. That means your stocks do not have an unlimited downside. When a stock goes down to a certain pre-determined low, we sell. Click here to watch what John has to say about the current market volatility.

RE-ENERGIZING THE ECONOMY

The Fed “reflates” the economy by injecting liquidity to stimulate borrowing and reduce risk premiums. Historically this has been accomplished by lowering rates, and today it’s being implemented through lower rates and “Quantitative Easing (QE).” Simply put, QE is the process by which the Central Bank buys long term securities in order to increase the money supply and encourage lending and investment. During previous bear markets the Fed gradually stimulated the economy by slowly cutting rates. This bear market was much shorter than its predecessors because of the unprecedented speed and magnitude of Fed actions in
March. The Fed balance sheet expanded from $4 trillion to $6.3 trillion in a month and will increase by $300 billion every week at the current pace.

In June, Federal Reserve Chairman Jerome Powell held a press conference to ease concerns that there would be a reduction in QE. Heading into the press conference, there was a justified concern that the FED would taper its QE program given the rally in risk assets, the partial reopening of the economy, and the rebound in some economic indicators. Powell reassured Americans that the FED is poised to provide more stimulus, not less. Below are the most important excerpts (full video and full transcript).

**POSSIBILITY OF A SECOND STIMULUS**

Additionally, at the beginning of Q3, Treasure Secretary Steve Mnuchin and Senate Majority Leader Mitch McConnell both indicated there will be a second round of stimulus money. President Trump has indicated he would approve this move. Since the Senate is in recess from August 10 to September 7, it is likely a decision will be made by early August and checks to individual citizens may go out as early as late August.

By the end of June, the Paycheck Protection program still had $130 million unspent. On July 4 President Trump signed a bill extending the deadline for small business loans under the program. In June, Trump had already signed a bill that loosened restrictions imposed by the bill. The new bill allows businesses 24 weeks to spend the money. Previously businesses had to spend the money in eight weeks. The June bill also allows businesses some leeway in spending the money on non-payroll expenses.

All of this indicates the Fed believes the downside economic risks vastly outweigh the risks of too much monetary stimulus, and it is unlikely there will be a tapering of QE in the near future. The government is waiting for the labor market to recover fully before reducing stimulus. According to Powell, the Fed will monitor economic conditions and is inclined to increase QE, which is bullish for risk assets and bearish for the US Dollar.

**BULLISH TREND**

Considering the market graphically you will see the extreme movement from the past four months. This chart shows the advance/decline line, which takes the net number of advancing NYSE stocks on a daily basis and sums that number from one day to the next. That creates the line you see. When the line moves up, there are more advancing stocks than declining stocks. The move lower means the opposite. The move to a new high is clear. Having that happen ahead of an S & P 500 (SPX) new high is
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Most bull markets begin with a burst of strength. On May 26, fully 91.7 percent of the institutional grade common stocks in our database rose above their 50-day moving average price (the stock price average over the last 50 days which often acts as a support or resistance level for trading stocks). This has happened 19 times since 1970. Had one bought on this thrust signal, one would have made a profit every time 12 months later. Although there is no such thing as a perfect indicator, this must be considered a bullish trend indicator.

In addition to stocks we have data to monitor this same breadth perspective in the bond market.
JCN’S CURRENT PORTFOLIO

"Earnings drive the stock market." Which is why the stock market always moves before earnings do, naturally. In addition to largely ignoring economic data, the stock market's rally is defying cratering earnings per share (EPS) estimates.

By the numbers: During the first five months of 2020 the bottom-up earnings per share estimate for S&P 500 companies has fallen by 28 percent to $128.03 from $177.82. (Bottom up investing involves focusing on an individual company's performance, rather than the company's industry as a whole)

- That's the lowest EPS estimates have been in the history of FactSet’s (a financial data analysis company) data, which goes back to 1992.
- During the past five years, the average decline in the annual EPS estimate during the first five months of a year has been 1.3 percent, and for the past 20 years, the average decline for the first five months of a year has been 2.4 percent.

Tech Giants Not only survived the COVID earnings crash but gained market share as a result.

As you examine our current portfolio, you can see this effect clearly. Companies such as Amazon and Microsoft not only survived the COVID correction but captured even more market share as people started working from home and shopped almost exclusively online. We expect this trend to continue and even potentially accelerate in the near term.
ELECTION RISK

The world has been understandably consumed by COVID-10, so the upcoming presidential election has not received as much attention from investors as it did during previous cycles. With the equity markets returning to pre-COVID levels, and November 3 less than five months away, the election is beginning to garner interest. Tax hike? The main pillar of the 2018 tax cuts was a reduction in the federal corporate rate from 35 to 21 percent. Joe Biden, the presumptive Democratic nominee, has proposed increasing the rate to 28 percent — removing half of the 2018 cut. Corporate tax breaks, loopholes, and skilled accountants pushed the S&P 500’s effective tax rate to a then-record low of 24.3 percent by the end of 2017. After the 2018 tax cuts, the effective rate fell 6.6 percentage points to 17.7 percent by the end of 2019.

Biden’s proposed 28 percent rate could decrease S&P’s Earnings Per Share (EPS) four to 13 percent. However, the Biden camp has floated other ideas, such as a minimum tax rate of 15 percent that could boost the effective rate further. Additionally, the 2018 tax cuts removed incentives to leave overseas profits offshore, which could explain why the effective rate fell so much less than the stated rate. Those are not expected to be repealed if Biden is elected.
$SPY Performance Surrounding Presidential Elections

(Zero'd Out on Election Day that Year)

- 1996 - Clinton R/E
- 2000 - GW Bush
- 2004 - GW Bush R/E
- 2008 - Obama
- 2012 - Obama R/E
- 2016 - Trump

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