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Ruth Bader Ginsburg, The Election, and the Stock Market

As if we needed anymore election anxiety, RBG's death raises the stakes of this already contentious election and that is **a headwind for markets in the near term. Here are the key <u>investment</u> issues:**

1. **To Replace or to Wait?** In recent years, Supreme Court selections have become substantially more controversial and partisan. The death of RBG as the election approaches puts this trend on steroids. **There is no 'moral high road' on this issue as each side is now arguing the precise opposite of what they were in 2016** when Republicans thwarted attempts to bring the Merrick Garland nomination to the floor before the election, arguing it was too close to the election. Democrats argued that the constitution demanded that the President make his selection and the Senate act on that selection. The tables have now turned. We have no idea how this will end, but we are confident that each side will pull out all the stops to win the day. **We view that as a massive headwind for the stock market over the next several months.**

2. **What Happens in a Contested Election?** Mail-in ballots mean we may not have the immediate election results that we are accustomed to on election night. It also raises the odds for charges of improper voting and in turn increases the odds of this election ultimately being decided in court. If we get that far, it would likely go to the Supreme Court. **A 'deadlocked' Supreme Court could effectively push this momentous decision back to a lower court as a tie vote at the Supreme Court would mean that the decision of the lower court would stand.**

3. **Has the Economy Been Put on the Back Burner?** Probably yes. The ramped up, partisan back-biting makes **a stimulus deal even less likely to be enacted, to the detriment of the economy**. Although we have been increasingly bearish on a stimulus deal, the market has clearly been more optimistic. Over the last several weeks, momentum had begun to swing away from the technology oriented COVID beneficiaries, to cyclical stocks, as the prospect of a vaccine and more stimulus would provide more confidence that the economy could truly re-open in 2021. When trading opened after the death of RBG, that trend reversed, indicating less confidence in that outlook.

In our view, while it may affect the short-term, the outcome of the election is unlikely to matter in the long run. If Trump succeeds in confirming a replacement for RBG before his term is out, you can be pretty sure that at the first opportunity, the Democrats will expand the size of the Court. If Trump fails, the process will return to something more normal (a term we use loosely). Either way, nothing much changes, but getting anything through Congress over the next few months will be close to impossible. **We appear to have a deal to avoid a government shut-down on October 1 and extend funding into December, but Congress will be hard pressed to make any compromises as the election and the SCOTUS confirmation will present challenges.**

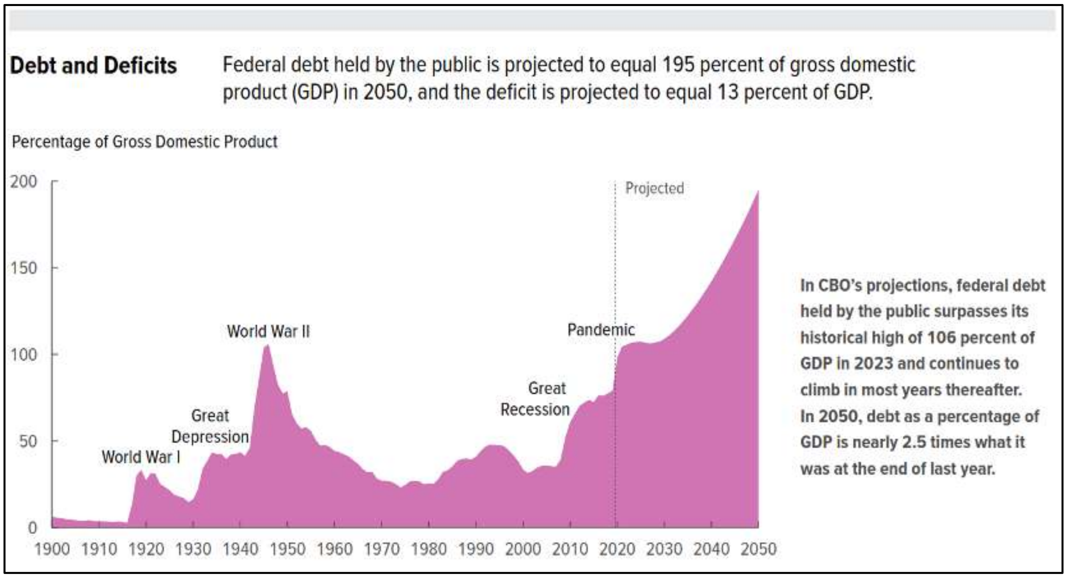
CBO: The Long Term U.S. Budget Trend is Not Healthy

Each year, the Congressional Budget Office publishes a report presenting its projections of what federal deficits, debt, spending, and revenues would be for the next 30 years if current laws governing taxes and spending generally did not change. The latest report was just published. In light of the highly politicized environment we have today, it is important to note that the CBO is not a partisan organization. Like a good umpire, they call ‘em the way they see ‘em. All of the charts below, with the exception of the last, are taken from the report titled *The 2020 Long-Term Budget Outlook* (a copy of the full 74 page report can be found here.)

The CBO also analyzed how those projections might change if productivity growth or interest rates were higher or lower than the CBO expects. **Even if economic conditions were more favorable than CBO currently projects, debt as a percent of GDP in 2050 would probably be much higher than it is today.**

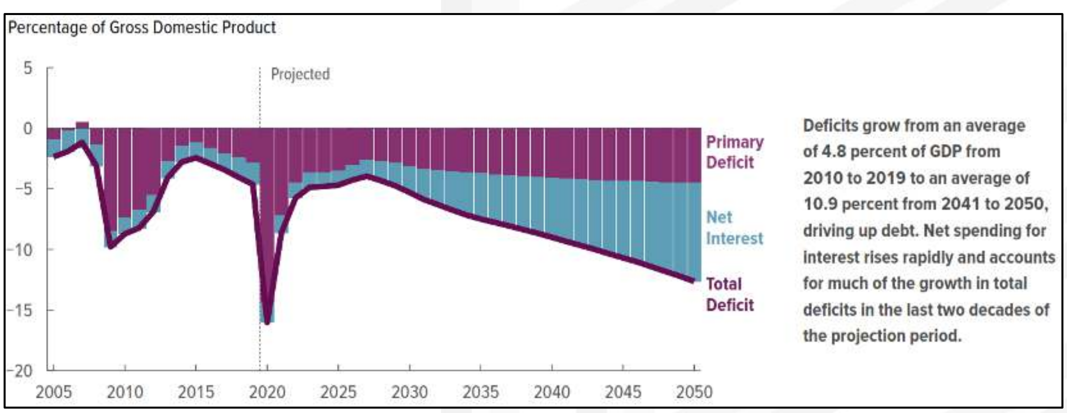
The new CBO projection is that debt as a percentage of GDP will be 45 percentage points higher in 2049 than was projected last year. The very large pandemic related deficits projected in 2020 and 2021 contribute to that growth, however, the fundamental revenue and expense balance is also expected to deteriorate.

Debt and Deficits. The pandemic is having a massive impact on the federal deficit, but presumably that is temporary. However, we should not take solace in the one-off nature of the pandemic. **Over the past 50 years, the average deficit has been 3% of GDP. In the new CBO projections, deficits, after COVID, are expected to run from 5% of GDP in 2030 to 13% by 2050.**



The result of the massive acceleration of debt issuance over the last 12 years and projections into the future begin to make net interest expense a sizable problem, not unlike a household over-burdened with debt. In the case of the US, **we are reaching an inflection point where net interest expense becomes the main driving force of the deficit increases,** as shown below.

One of the hidden reasons for FED keeping a lid on interest rates is that higher rates only accelerate this problem. **It very difficult to determine the 'point of no return' where it is essentially impossible to grow our way out of our debt because interest is growing too rapidly, but that point does exist.**



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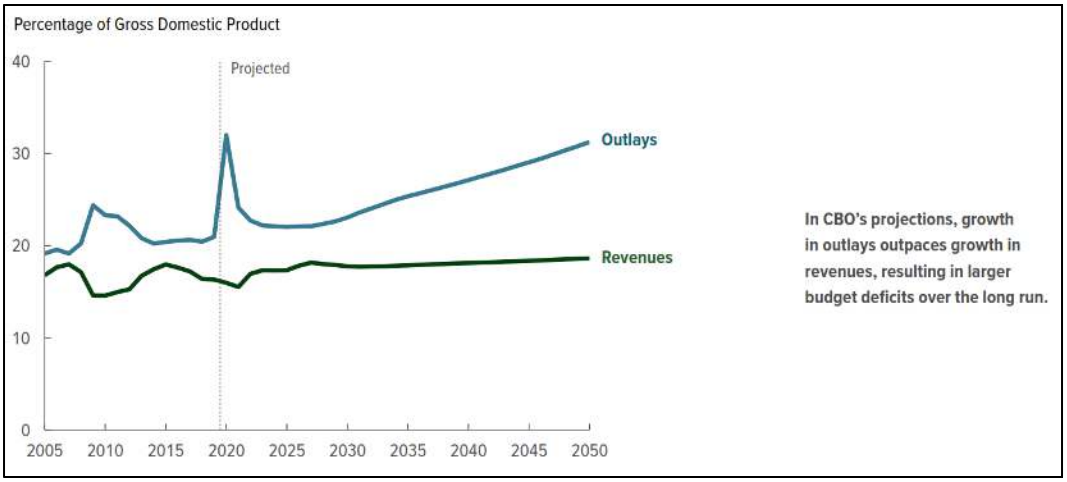
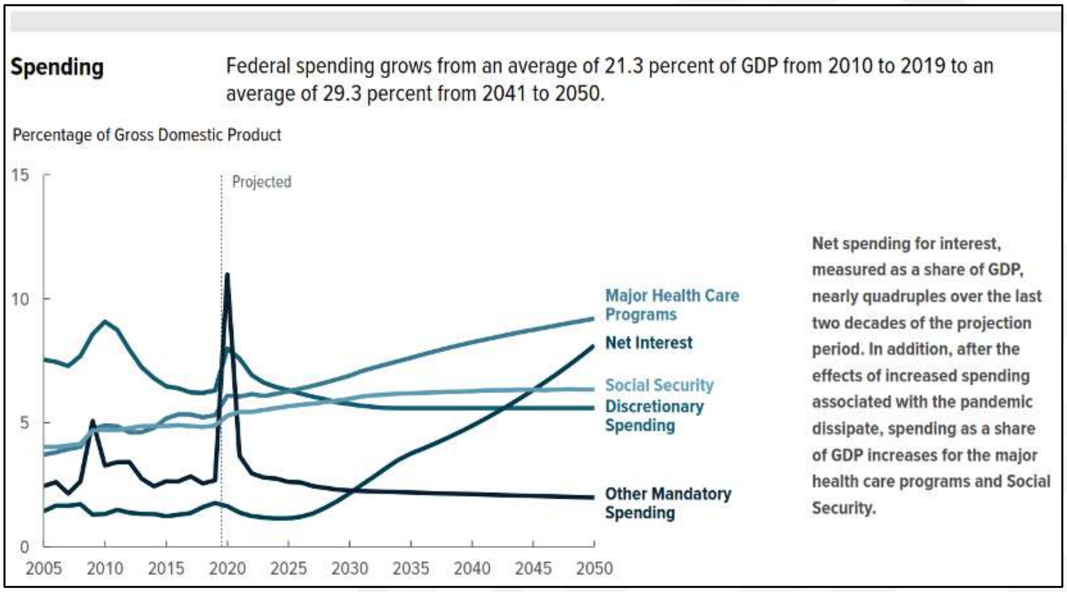
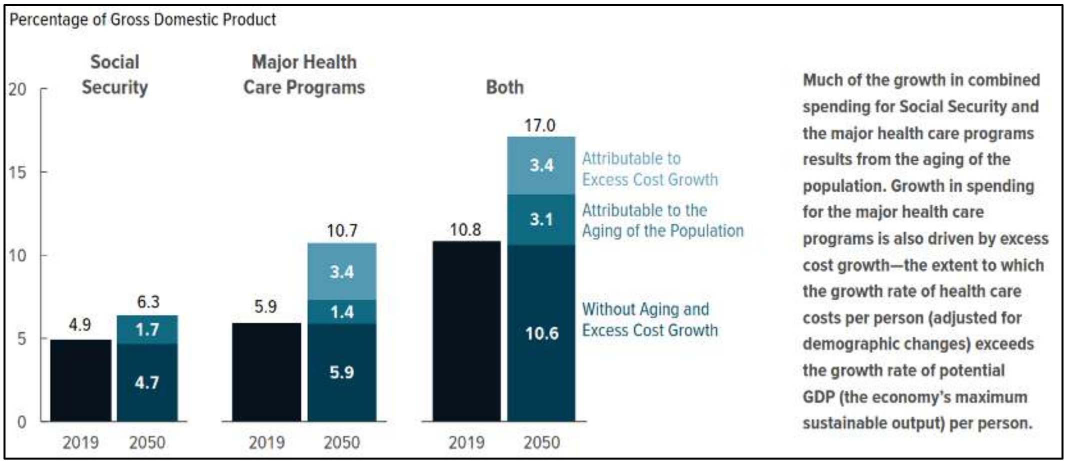
The theme this election is tax the rich, but the chart below indicates that taxing the rich will not be nearly enough. **No matter who is elected, we can all expect taxes to rise. The situation simply demands it.**



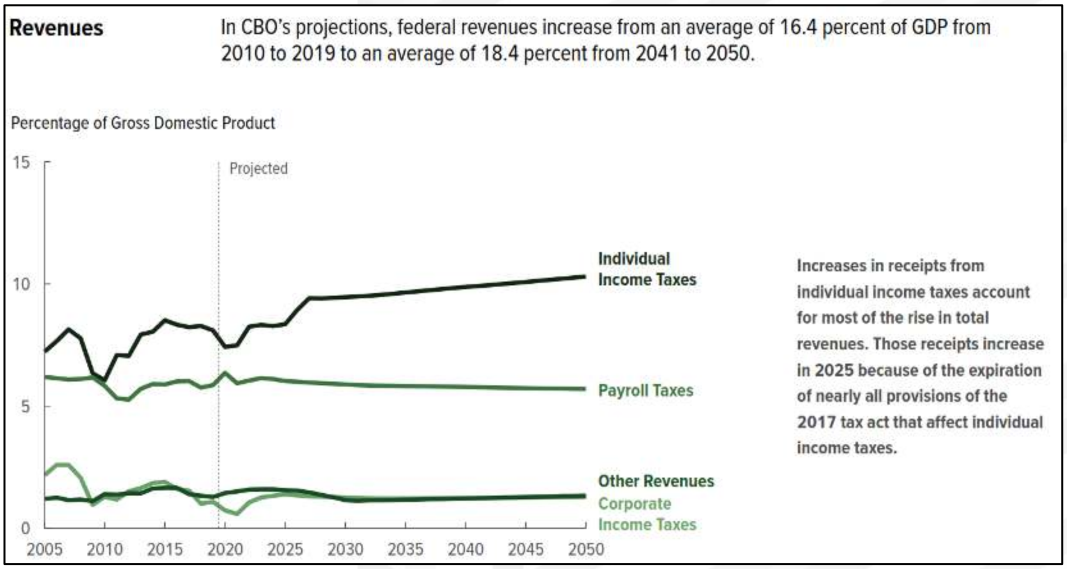
Spending. The combination of growing debt and higher interest rates results in a projection that **net spending for interest on the debt almost quadruples in relation to the size of the economy over the long term and this accounts for most of the growth in the total deficit**.



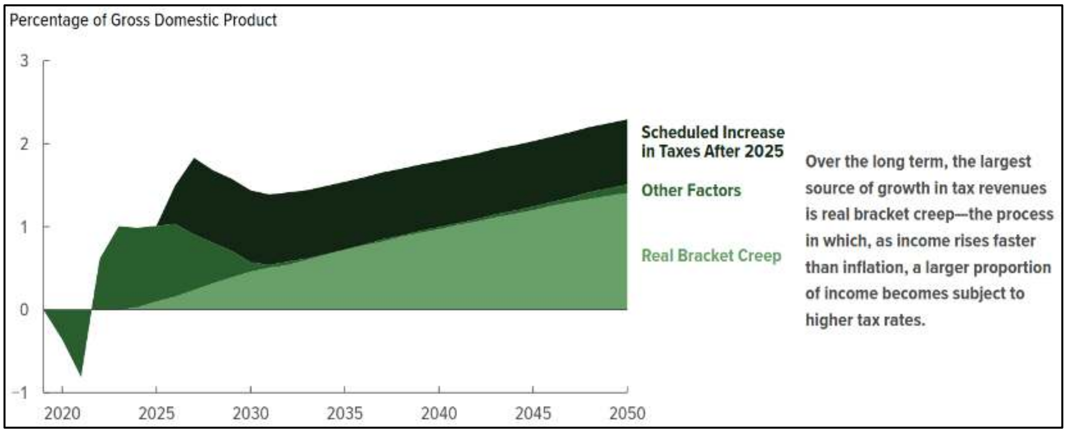
The chart below summarizes the expected costs of Social Security and Health Care Programs as a percent of GDP. On a combined basis over the next 30 years, these two categories are expected to grow from 10.8% to 17% of GDP due to the aging of the population and 'Excess Cost Growth" which is the extent to which cost growth exceeds potential GDP growth. **It is clear that some restructuring of entitlement programs will be necessary to avoid a financial train wreck in the long run.**



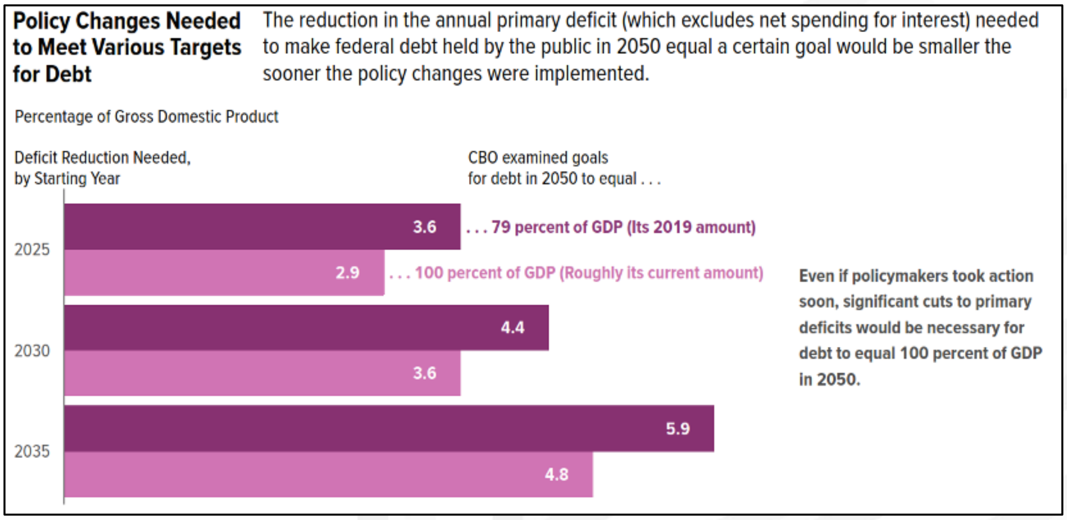
Revenues. Clearly the pandemic has caused a substantial drop in revenue, but **after the pandemic ends revenues, as measured as a percentage of GDP, are projected to return to a growth trend**. The projected revenue increase in 2025 is due to the expiration of the 2017 tax act. After 2030, the bulk of revenue increases are derived from an increasing share of income being pushed into higher tax brackets (bracket creep) and **individual income taxes revenues do not keep pace with the growth in spending.**



The increase in individual income taxes is largely due to bracket creep, which is the hidden way Congress increases taxes.



Serious policy changes are required if we are to avoid this type of future, and the longer we wait, the more drastic the changes will need to be. We need to stop leaning on statements such as "We are the richest country in the world, we can afford it." The data says otherwise. **We are a wealthy country, but even our wealth has limits and this report clearly implies that we are reaching that point rather quickly.**

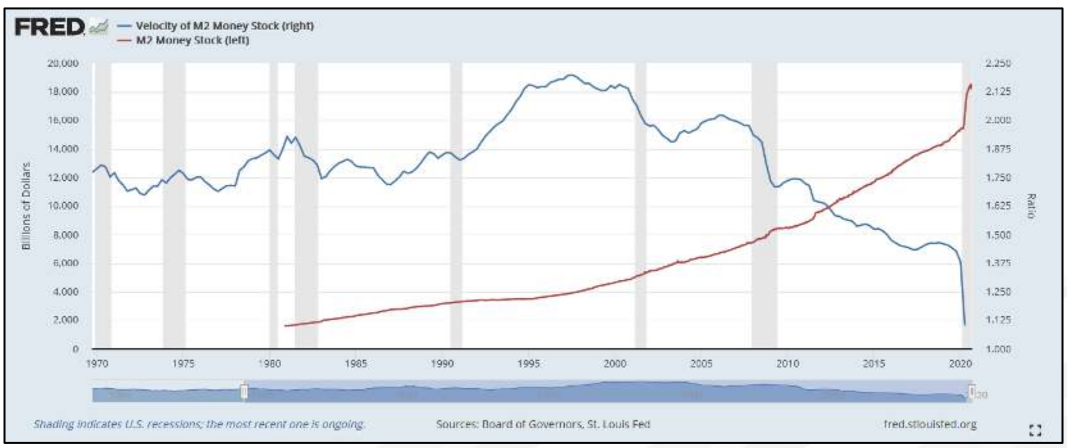


As we outlined several weeks ago, **there are a limited number of ways to extract ourselves from this fiscal predicament – The first and best option is to grow our way out of it, but our growth real growth rate continues to slow.** The CBO report projects real GDP to grow at an average of 1.6% over the 2020-2050 timeframe. This is substantially less than the 2.5% average real GDP growth over the last 3 decades and is 0.3 percentage points less than the estimate from last year's report. The bottom line is that, at this point, the odds of the U.S. being able to grow it way out of this fiscal dilemma are very small

Another option is a debt restructuring (i.e. a default). As the world's reserve currency, that is an untenable outcome and it is very unlikely that the U.S. would choose that road and abdicate reserve currency status.

The final option is inflation. The late, noted economist, Milton Freidman, once said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." If he is correct, we have started the process of creating inflation.

As shown in the chart below, the money supply (red line) is rising very rapidly as debt is monetized, but this is currently being offset by a collapse in the velocity of money (the number of times an average dollar is used over the course of a year). The velocity has actually been in a steady decline since the Great Recession of 2008, but has recently collapsed due to the pandemic related lock-downs. **At some point, when velocity rebounds, inflationary pressures should begin to build in the economy.**



This inflation, if it comes, is also likely to threaten the dollar's reserve currency status in the long run and makes it very important to maintain inflation hedges in portfolios, despite the current lack of inflationary pressure.

These possible outcomes only add to our conviction at Palumbo Wealth Management that a highly diversified portfolio seeking indifference to outcomes is the correct way to approach the future.

What We're Reading

- Visits to U.S. stores, restaurants stall as recovery concerns grow
- Europe is facing a double-dip recession as second wave arrives
- Filling a Supreme Court vacancy in an election year is complicated
- Trump Plans to Nominate Amy Coney Barrett to Supreme Court
- Carbon-Sucking Bionic Weeds Are New Front in Climate Change War
- ConocoPhillips sees global oil demand returning
- Battle for the Senate 2020
- Stock swings keep investors on edge
- Fed's Bullard says 'biggest growth quarter of all time' will lift inflation
- Initial Jobless Claims Edge Up, but Continuing Claims May Be Easing

The above headlines are from multiple sources, including, Reuters, The Wall Street Journal, The NY Times, Bloomberg, Barron's, and CNBC.

Markets This Week

It was a schizophrenic, up and down week that closed on a high note with Tech/Growth again leading the way while the reflation trade fizzled. That produced a modest flight to quality sending long term treasuries up almost 1% for the week. The flight was from a broad swath of the market, but Energy, continued to lead the way down with a 10% decline for the week. Materials, Financials, Gold and Commodities are notable among the other substantial losers, although most every other category declined for the week.

US Equities	1 week	YTD	Fixed Income	1 week	YTD	Sector Breakdown	1 week	YTD
S&P 500 (SPY)	-0.58%	3.19%	20+ Yr. Treasuries (TLT)	0.95%	22.89%	Consumer Disc. (XLY)	0.02%	15.58%
Dow (DIA)	-1.74%	-3.51%	Barclays US Aggregate (AGG)	-0.08%	6.40%	Info. Technology (XLK)	1.95%	25.29%
NASDAQ (QQQ)	1.76%	28.22%	Intermediate Municipal (MUB)	-0.01%	2.96%	Financials (XLF)	-4.82%	-22.55%
Russell 1000 Growth (IWF)	1.17%	21.17%	US Corporate Bonds (LQD)	-1.11%	6.47%	Health Care (XLV)	-2.39%	2.06%
Russell 1000 Value (IWD)	-3.33%	-13.54%	Barclays US High Yield (HYG)	-1.59%	-3.15%	Utilities (XLU)	0.34%	-7.45%
Vanguard Mid-Cap (VO)	-1.38%	-2.07%				Industrials (XLI)	-2.91%	-4.97%
Vanguard Small-Cap (VB)	-2.78%	-8.41%				Energy (XLE)	-10.21%	-47.95%
						Materials (XLB)	-4.96%	2.93%
International Equities	1 week	YTD	Commodities	1 week	YTD	Consumer Staples (XLP)	-1.02%	1.45%
MSCI EAFE (EFA)	-3.15%	-7.87%	Commodities (PDBC)	-3.55%	-18.06%	Comm. Services (XLC)	-0.37%	9.65%
MSCI Emerging (EEM)	-3.55%	-3.74%	Gold (GLD)	-4.51%	22.42%	REITS (VNQ)	-3.07%	-14.77%
						Homebuilders (XHB)	-2.24%	14.95%

The table above is an analysis of the weekly and year to date returns of various markets/sectors that we follow (More RED = worse performing markets/sectors; More GREEN = best performing markets/sectors). Source: PWM Research

Retirement Planning:

How to navigate volatile markets during retirement

The stock market has been subject to heightened volatility. Financial advisors say that retirees with investment portfolios shouldn't let it spook them – instead, it's a good time to stick with a previous plan.

Tax Planning:

[A Roth IRA may help fund your home purchase. Here are the Pros and Cons]

Up to $10,000 in Roth IRA earnings can be withdrawn — free of both taxes and penalty — for a home purchase if you meet certain requirements.

Estate Planning:

[The 2020 Election and the Estate Planning "Perfect Storm"]

Many believe a major legislative change to the estate tax is coming depending on the outcome of the November election,

Health:

[Experts emphasize importance of flu shots]

Health experts from Johns Hopkins University in Baltimore are warning of a flu and coronavirus "twin-demic".

Entrepreneur:

[How Great Leaders Bring Out Others' Self-Confidence]

Leaders inspire and enable others to do their absolute best together to realize a meaningful and rewarding shared purpose.