"Investment News for the Educated Investor"

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THE ALOOF/MATTOS REPORT

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Big Gains in November Steal from Santa?

December's A Strong Month for Stocks

Since 1950, the S&P 500 has been up 1.5% on average in December, the second best month of the year. Stocks have been up 2% on average when the year-to-date return was 10% or more heading into December. Election-year Decembers also have been strong—could December deliver more gains in 2020?

What a month November was! Here are some of the highlights:

- Best month for Dow since January 1987 (11.9%) and best November since 1928
- Best month ever for the STOXX 600 (16.7%)
- Best month ever for the Russell 2000 (18.3%)
- Best month for the S&P 500 (10.8%) and Nasdaq (11.8%) since April 2020
- Best month for Dow Transports since October 2011 (12.1%)
- Best month from PHLX Semiconductor Index since March 2003 (18.4%)
- Best month for Industrials (16.0%) and Financials (16.8%) since April 2009
- Second best month ever for energy (28.0%)*

"A way better than expected earnings season, a likely split Congress, and major breakthroughs on the vaccine front all helped stocks soar last month," explained LPL Financial Chief Market Strategist Ryan Detrick. "Add ongoing support from the Federal Reserve as the cherry on top and we are looking at a truly historic month on many levels."

Last month was the best return since January 1987. Now before you go out and sell because you see 1987, remember the S&P 500 added another 20% the seven months after the huge gains in early 1987. It was the best November for the S&P 500 since November 1928. Small caps soared on the likelihood of taxes staying lower due to a divided Congress and vaccine progress, with the Russell 2000 adding more than 18% for the best month ever, topping the previous record from February 2000.

What happens after a big month? Well, history says a 10% monthly gain is quite bullish. In fact, we had a 10% plus rally back in April 2020 and shared this same chart at that time. Sure enough, returns have been strong this time around as well. "The bottom line is the huge gains in November could actually be the start of something much stronger," according to Ryan Detrick. "Also, this was the second month of 2020 with a 10% gain. The only other year to do that? 1982, which kicked off a historic bull market."

Turning to December, this month is widely known to be quite bullish, as Santa comes to town, people feel good, and stocks tend to do well. As shown in the LPL Chart of the Day, since 1950, December has been the second best month of the year, with only November better. December had been the best month of the year until the historic 9.2% drop in 2018. As a result, December hasn't been quite as strong over the past 10 and 20 years.

Breaking it down even more, a big

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rally in November can potentially steal some of December's thunder. As after a 5% or 10% rally in November, the returns in December are more muted. The flipside to this though is if the S&P 500 is up more than 10% for the year (like 2020), then stocks have benefited from some performance chasing and have tended to do better.

What does it all mean? After the historic move in November we wouldn't be surprised to see below average returns in December. We do believe this is a new bull market and lasting economic cycle of growth, but overall sentiment is getting quite stretched and this increases the potential for some near-term weakness.

S&P 4,200—Dow 35,000

Special Guest Columnist
Brian Wesbury—Chief Economist
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In December 2019, we made a year-end 2020 forecast of 3,650 for the S&P 500. With the index closing Friday at 3,638, that looks like a very good call.

But we'd be fibbing if we didn't admit to getting whipsawed by COVID-19. In the spring the S&P 500 fell as low as 2,237, pricing in a massive drop in corporate profits. We remained bullish but revised our year-end forecast down to 3,100. Then, in August, after analyzing data on COVID-19 and assessing the actual impact of shutdowns on growth and profits, we lifted our year-end S&P target for 2020 back to 3,650.

For next year, the fundamentals continue to suggest a bullish outlook. Our year-end 2021 call for the S&P 500 is 4,200 (up about 15% from last Friday), and we expect the Dow Jones Industrial Average to rise to 35,000.

We rely on our Capitalized Profits Model. The model takes the government's measure of profits from the GDP reports, discounted by the 10-year US Treasury note yield, to calculate fair value. And, last week, corporate profits for the third quarter were reported at a record high, up 3.3% from a year ago.

The question is: what discount rate should we use? If we use the current 10-year Treasury yield of 0.84%, our model suggests the S&P 500 is grossly undervalued. But this is because the Federal Reserve is holding the entire interest rate structure at artificially low levels. Using these rates distorts valuations.

Using third quarter profits, it would take a 10-year yield of 2.8% for our model to show that the stock market is currently trading at fair value. And that assumes no further growth in profits.

Right now, in spite of Fed pressure to hold rates down, we expect the 10-year note to finish 2021 in the range of 1.25% to 1.5%. Nonetheless, we have chosen to use a more conservative 2% discount rate in our Capitalized Profits model. Using third quarter 2020 profits, that creates a fair value estimate for the S&P 500 of 5,150. And this does not take into account the highly likely boost to profits in the year ahead. As a result, we believe our year-end 2021 forecast of 4,200 is easily within reach.

Obviously, the year ahead is not without risk. Perhaps the various vaccines will be rolled-out more slowly than anticipated. Perhaps, the Georgia Senate elections in early January result in a House, Senate, and White House that all agree to more aggressive tax hikes than markets currently anticipate. Perhaps, perhaps, perhaps.

More likely, we anticipate the vaccines will work roughly as advertised, and businesses will continue to improve in handling the obstacles posed by the illness and government shutdowns alike. Meanwhile, the Senate should remain a check on aggressive tax hikes, and the federal courts may curb excesses in regulation. New entitlements? Highly unlikely. In addition, it looks like trade conflicts with other countries will ease.

We have been bullish since 2009, not because we are perma-bulls, as our detractors like to say, but because the fundamentals say we should be. Profits and interest rates drive stocks, we let these factors determine our outlook. Not politics, not fear, not greed…just math.

Investing Reminders from Dave & Jerry:

Market volatility is an inevitable part of investing.
If we never had market sell-offs, we wouldn't have as much opportunity to see returns.

Markets trend upward. While the past can't tell us what the future holds, the past 30 years have had upward-moving markets despite recessions. It makes sense that this would continue since investors see opportunity in undervalued stocks.

Trying to time the markets may not end well. If you sell out of the market during a decrease, you "lock in your loss," because unless you buy back in at just the right time, it can be difficult to recover the amount you lose—and the very best days tend to happen right after the very worst ones.*

Understand your strategy. Your strategy was designed for your specific goals, timeline, and risk tolerance.

Review your needs and goals. This is a great time to determine if your goals and objectives remain the same, or if they've shifted, requiring an update to your strategy.

Stick to your strategy. Your strategy was built for your individual time horizon, and sticking to it will position you to work toward your goals.

** There are six examples in the S&P 500 since 1987 of deep declines that were followed within 10 days by big moves to the upside. The S&P 500 is generally considered representative of the U.S. stock market. Past performance is no guarantee of future results.*