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Q&A-Stocks already reflect vaccine optimism, now looking for next support: David Wagner, Aptus Capital Advisors

Reduced incremental optimism in response to more recent COVID-19 vaccine trial data shows good vaccine news is already priced into stocks, **David Wagner, portfolio manager at Aptus Capital Advisors**, told the Reuters Global Markets Forum on Tuesday, November 24.

Wager, whose firm has about $2 billion in assets under management, says the outlook “six months from now has turned positive for stocks because of the vaccines, historic central bank stimulus, likely more fiscal stimulus," albeit cautioning that the latter should be expected in February at the earliest, due to political differences between Republicans and Democrats.

Following are edited excerpts from the conversation:

Q: What do you make of the U.S. Federal Reserve's actions this year in markets and how potent do you think monetary policy will be in 2021?

A: The Fed's quick and large intervention this year was remarkable by my estimates -- it's boosted earnings by 30% already this year. In fact, right now, we see the S&P 500's NTM EPS (Next Twelve Months, Earnings Per Share) expectations to be only 15% lower than where it was in early February. This is the smallest drop of S&P 500 EPS during a recession since 1960.

Given the current situation in Washington and Biden's announcement of Janet Yellen for the Treasury chair yesterday, I’d expect the Fed to be on the forefront of the incoming party's agenda, especially since we may continue to see a lame duck Congress. I don't expect much stimulus to occur before the Georgia runoff and even before a potential government shutdown. Congress' eyes are elsewhere right now.

Q: So, if Fed policies towards corporate credit are to change in '21, how do you see that happening?

A: I think there are more levers for (Fed Chair) Jerome (Powell) to pull in the future, as he's stated that a few months ago from a QE (Quantitative Easing) perspective. The market has focused on the Fed's commentary on QE over the past few months. For example, when in September the market was disappointed that the Fed did not change their QE language - the market sold off a bit.

Obviously, it will not come in the form of lower rates, but Jerome and Janet are both considered Doves, so I think there is more runway right now in the form of QE to continue to help in the future. Additionally, multiple programs that could be re-enacted regarding corporate credit, which will be front and center in 2021, especially if we continue to see some sort of targeted lockdowns.

Q: What corporate credit programs do you feel could be re-enacted next year?

A: There's been a lot of talk on the (Federal Reserve Act Section) 13(3) programs right now as they roll off on Dec. 26. That's why the Yellen decision is pretty substantial as she understands (along with Jerome) that it's all about communication with the market.

The Fed's commentary will continue to act as a backstop -- whether they use any of the programs or not. But there will be messaging in place to make corporations feel that they will be protected. No doubt the market wants to see more corporate programs - I think it expects it, especially if the COVID case rise continues, but the market is putting more emphasis on QE language.

Q: It's been quite a month with the U.S. election, what are your views on market volatility and what's the outlook for covered call option writers as we close out 2020?

A: I think the market’s internals and price action reflects the reality right now -- that it’s caught between daily, negative COVID headlines and a lack of stimulus -- and a like more positive future i.e. stimulus delivered, vaccine. This dynamic -- the push and pull -- will likely increase volatility over the coming weeks, as we learn of the extent of lockdowns (how much worse will it get) and a better expectation for whether any stimulus at all is coming before February.

Not to mention, on Friday, Treasury Secretary Mnuchin made remarks about his decision to bring multiple Fed lending programs to an end suggesting the use of grants instead, which was negatively received by markets as a less-accommodative Fed.

The underlying theme here is that we believe there could be increased volatility in the future. We, unlike many investors, see volatility as an asset class and we love to take advantage of it.

Per covered calls – obviously, this is an extension of some type of volatility hedge. Investors are looking for additional yield in the low interest rate environment. Like the song from Johnny Lee, investors need to be looking for yield in unexpected places, and covered calls is a great way to find additional yield in an unexpected place.

It has been very surprising to me on how yielding stocks have performed this year, given the downturn and volatility - so we'd still love yielding stocks to outperform going forward.

But back to volatility, look at some of the recent large announcements. Stocks didn't rally materially on the Moderna and AstraZeneca vaccine news the past two Mondays and we think that's important to note as it shows that good vaccine news is already priced into stocks at these levels.

Practically speaking, the market is focused on new catalysts that will decide the next near-term direction of stocks and those catalysts are COVID cases -- how bad it gets in the next few weeks -- and stimulus i.e., when, and how much.

Put more frankly, we know the outlook six months from now has turned positive for stocks because of the vaccines, historic central bank stimulus, likely more fiscal stimulus, and resilient corporate performance. But what we do not know yet is how much exploding COVID cases and increasing lockdowns will weigh on economic growth over the next few months. That matters, because if it's a lot, then that just leaves a bigger figurative "hole" for the economy to climb out of once the vaccine is distributed and life returns to normal (hopefully sometime around April).

Q: What do you think sector performance in 2021 will look like, David?

A: For sectors, we thought a vaccine announcement would be a catalyst that could make the growth to value rotation finally have some staying power over the medium to long term, and obviously one of the ways to position for that is by reducing positions in growth funds/super-cap tech and rotating it to value funds and industrials, materials, energy, financials/banks and small caps.

We have been talking about the rotation from tech/growth to cyclicals/value on and off for months, but only recently received the catalyst that we believe makes this rotation sustainable over the medium and longer term i.e. the vaccine.

We continue to not fully buy into the cyclical value play just yet. If you look at a few periods over the last year, they've had a fitful rally but hasn't been sustainable. But we think this play has a longer runway than before, given the aforementioned items, so we are starting to slowly dip our toes into playing this theme.

Q: Given the gap between vaccine headlines and actual implementation, do you think a move into value right now would be prudent or should investors wait until the outlook six months from now, as you mention, clears up a bit more?

A: Investors should be excited about these long-term positives, but we believe there is still some concerning outstanding data that could cause some near-term volatility, as we believe that market continues to price in some very positive news. There are ways to play this in the market in our opinion. I hate this cliché, but it's your time in the market and not timing the market. We know equities over the long-term are positive, especially versus bonds, but there may be some short-term chop.

There are multiple "reasons" for the pullback, but in the end the commonality between them all is economic growth. If there's a split Congress, then there's delayed stimulus and that's bad for growth. If there's a divided government, then there's no massive stimulus in 2021 and that's bad for growth. If governments reimplement lockdowns in response to surging COVID cases, that's bad for future growth.

Q: Given Fed involvement in junk bonds this year, if you were to put a number to how much investment grade (IG) credit is likely to broadly return next year, what would it be?

A: At Aptus, we don't like to give an estimate on what we'd expect returns to be.... we are very surprised where spreads currently sit between HY (high yield) and IG, given the year that we've had.

Q: On the policy front do you expect more fiscal stimulus after the January runoff, especially given Yellen at the helm of the Treasury?

A: Stocks rallied at the end of last week mostly on headlines that implied stimulus negotiations had resumed between Senate Majority Leader McConnell and Senate Minority Leader Schumer, but despite the positive headlines and shift in tone, we do not think investors should expect any large-scale stimulus until February at the earliest, mainly because of politics.

The likely real reason that fiscal negotiations resumed last week is because the U.S. government is facing a budget deadline on December 11. If a new continuing resolution is not agreed to by then, we'll have another government shutdown. No one, especially politicians, want a government shut-down in the middle of a pandemic. So, in all likelihood, the budgetary can will be "kicked down the road" in a few months and the government will stay funded.

To accomplish that, members of Congress will likely not address any of the issues involved in stimulus discussions and leave those tougher conversations for a later day. Bottom line, any positive fiscal headlines from Washington in the coming weeks will likely have more to do with the budget, and not COVID stimulus.

Given the $1 trillion difference between parties, we'll split the fairway with a driver and go $1 trillion total, as high-frequency data continues to be strong. But in the end, there is a disconnect between Wall Street and Main Street, and Americans need some type of income support. The consumer is like Atlas, if the consumer shrugs, the whole economy could falter.

Q: Any parting thoughts for us?

A: We continue to really analyze the antiquated 60% stock - 40% bond asset allocation. The 60/40 portfolio is like a storm trooper from Star Wars. Good in theory, as they are the best fighters in the galactic galaxy. But whenever the storms troopers shoot, they miss their intended mark and that's exactly what we think of the classical 60% stock/40% bond portfolio. We worry about the safety valve from traditional income is gone. Longevity risk has never been higher for investors.

The biggest decision an investor can make is on asset allocation. The biggest risk an investor has is longevity risk. Investors are forced to think that their allocation is right because there is not a great solution to the longevity risk affecting them in the current environment. Everybody is aware of this issue, but no one has the solution to address the problem. The other alternatives are expensive or expose investors to other types of risk. We solved this longevity risk/low interest-rate bond problem with our bond alternative strategy.

Our bond alternative strategy, short-term in nature, is 95% (laddered) bonds with a 5% exposure to equity call options, plus a notional value hedge on the market through put options. The 95% bonds give you the desired bond exposure, but we limit our downside with the notional put options and that gives us above average return potential with a basket of equity options. We believe a basket of options is better than an option on a basket.

Q: Do you advocate for more stock exposure and income from selling out of the money call options? So, that's 75 stocks-25 bonds, effectively?

A: It's rare for stocks and government bonds both to fall in value together, but this happened in March -- a basic 60% stocks and 40% Treasury portfolio suffered one of the worst single-month declines since the 1960s.

And I hate to quote an Imagine Dragons song, but we are in a "new age" of investing, and we believe that our bond alternative hits the mark on how to give desired exposure, circumventing longevity risk for investors.

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