Market Commentary

December 31, 2020

Respite anyone?

We can speculate that the most requested gift this holiday season has been a respite from, well, just about everything. The virus, political rancor, travel bans, financial repression, economic shutdowns, lofty equity market valuations, facemask debates, market volatility, sensationalized news, economic uncertainty, concentrated equity market performance, and politicians. We are not optimistic we will experience a respite from everything, but maybe from some.

We hope you and your family are safe and our best wishes for 2021, respite or no.

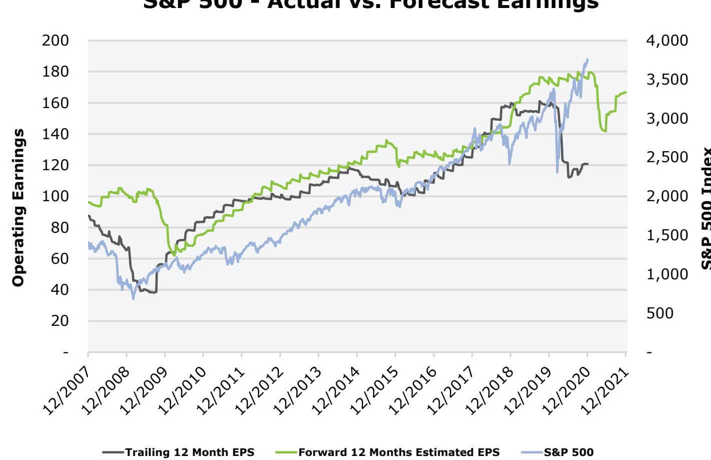
Financial repression is a broad term that describes many government policies, most notably low interest rates. Low interest rate policies have been adopted as a tool to stimulate the economy. However, there is a point when the policy becomes counter-productive or, at a minimum, loses its impact.

Low interest rates have reduced borrowing costs for the public and private sectors, with one result being record high levels of debt relative to the size of our economy for both sectors. Conservative investors have been forced to take additional risk in attempts to maintain income. Zombie companies (those that cannot make enough money to pay their interest costs) survive longer than normally expected. The Federal Reserve interest rate policy outcomes have become asymmetrical. Lower rates do not help much. Higher rates would kill a lot of things in today's economy. Some argue, with good evidence, that extended periods of low interest rates actually suppress economic growth because capital is not allocated to productive uses.

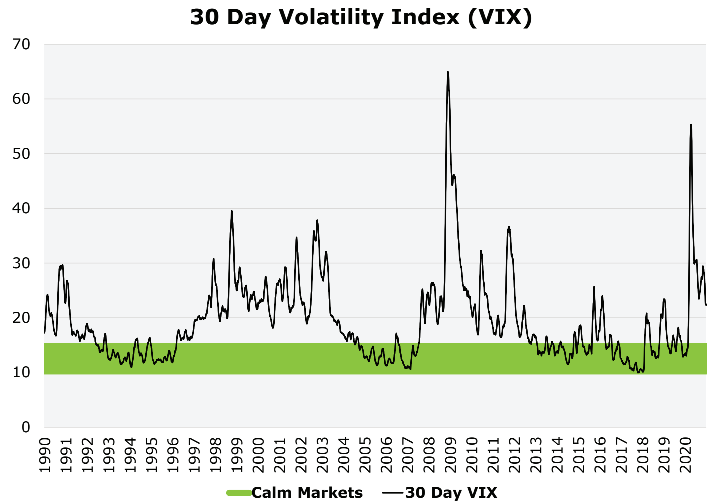
It will be some time until short-term rates are increased because the Federal Reserve is going to accept higher inflation for a while – just to make up for lost time. Barring renewed recession, we expect higher inflation near term, which should push longer-term bond yields higher. We recently covered the outlook for inflation in a special commentary, where we overview the dynamics of inflation and deflation, what factors are contributing to each in our economy today, and what we expect to unfold in the future. **Click here** to download the commentary and learn more.

Equity market valuations remain high by most measures. The stock market price to earnings ratio (P/E) on trailing earnings is 31 and in the highest percentile of its history. We should expect this number to be somewhat high because of the lower earnings (or losses) from the springtime recession. Earnings are rebounding and looking forward to next year. The P/E on expected earnings is 22 which still ranks in the highest 20% of history. Not at record levels but high.

In order to experience the median P/E, stock prices would need to fall 25%. Or earnings would need to increase an additional 32% from levels already baked into the forecasts for next year. Currently, earnings are expected to recover from pandemic recession levels by the third quarter. It is unlikely we will see an additional 32% gain. Current valuations suggest that today is not a good time to aggressively increase allocations to stocks.



Equity market volatility remains relatively high, which is not surprising given we have seen two bear markets and two bull markets over the last 2¼ years. Today's relatively high P/E levels suggest that market volatility is not going to suddenly return to lower levels.



Concentrated equity market performance has pushed the largest 5 stocks to represent approximately 25% of the S&P 500 market capitalization. The performance of these stocks has an outsized effect on market "index" performance. The S&P 500 index returned 18.4% for the year. Remove 3 of the largest companies from the index and the return was 8.6%. The average stock in the S&P 500 gained 12.8% (based on the unweighted average).

Over the last two months we have experienced a broadening of the market with small companies and equal-weighted indices out-performing the large cap leaders. If this two-month trend continues, it will bode well for future equity market returns. Broader economic recovery and higher inflation would help this trend to continue. Until then we must be wary of this short-term trend reverting back to the concentrated market leadership of the last couple of years.

The virus and related public policies will change as vaccinations become widespread or the virus burns itself out as many of these have done in the past. We imagine there is a small risk of a failed vaccination program, but more likely the virus-related policies will gradually fade. Respite? Yes, but not overnight.

Government policy creep is notable. We appreciate the advice from our public health officials and accept the scientific foundations that are cited. What surprises us is the extent of fiscal and monetary policy measures implemented. A simpler approach seems more reasonable.

Take Canada for example. They simply provided enhanced and extended unemployment benefits for affected individuals. The U.S. has implemented similar measures but only for finite periods of time. As these programs near expiration, another raucous football game breaks out in D.C. Why not implement the policy for the duration and be done with it? And why send money to people who are not negatively impacted by government mandated shutdowns? Why provide money to companies, municipalities, or states that were fiscally mis-managed?

Many companies that have suffered pandemic-related revenue declines have spent multiple billions of dollars buying back stock over the last ten years but did not have enough reserves to work through a 6- to 12-month downturn in business. Low interest rates have encouraged the stock buyback programs.

The respite is coming but not overnight, and it will be irregular. We are quite confident of two things: First, that Americans are resilient and inventive—enough so to effectively bridge the gap to our respite. And second, that politicians will continue to be politicians—doing the same things they've always done.

Your AAMA Team

Want to Discuss?

If you would like to discuss this content, please feel free to reach out to our President, Bob Baker, at **614-726-3622**, or our National Sales Manager, Aaron Ploscowe, at **614-726-3627**. We'd love to speak with you.

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