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Private Wealth

Chairman's Market Commentary

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Let's start with a broad overview of where we are and where I think we might be headed.
Right now, the news is pretty encouraging.

- The US seems to be moving to a new and hopefully kinder and more inclusive administration.
- An additional $900 billion in government stimulus has been approved and President Biden is preparing to ask for an additional $1.9 trillion. Economists now believe that government spending can bridge the COVID gap until we reach vaccine stability.
- COVID-19 vaccines are being rolled out which promises a "coming out" party by the second half of this year as the service side of the economy recovers.
- Federal Reserve Chairman Powell has confirmed that the Fed will maintain its ultra-easy monetary policy.
- Fourth quarter earnings reports are so far coming in ahead of forecasts.

So, things look pretty good and the market averages are reflecting this by reaching new all-time highs.

But, what's ahead and what could go wrong?

At some point the market will look ahead to where we will be in six months if all this plays out. If the economy is at full throttle, it will start to absorb some of the liquidity that has fueled this market. In a normal cycle, the Fed injects liquidity into the system during a recession. It isn't initially used by businesses and consequently flows into financial assets. Bond prices go up, interest rates decline and the stock market recovers. But as the economy recovers it eventually needs some of the liquidity to sustain itself. Inventories have to be rebuilt, capital spending picks up and more people are hired.

And where does this money come from? Usually, the financial markets.

So, if the economy is screaming by next fall, as some economists forecast, I'm not sure that will be good for equities.

Furthermore, the market seems to have dismissed Biden's election agenda as his initial focus is likely to be resolving the Corona virus pandemic. But later this year, the emphasis is likely to shift to his stated objectives which now look to be on the 2022 agenda.

This might include:

- Higher corporate and individual taxes
- Higher regulatory oversight
- New Social and Economic policy
- The Green new deal
- Health care reform
- Student loan forgiveness
- Spending on infrastructure
- Higher deficit spending
- A concern that the Blue Wave turns into a tsunami of social policies implemented by progressives which will represent a radical regime change from the Trump Administration.

Although this might give the market some cause to pause, the reality is that the Democrats don't likely have enough votes for sweeping change. Votes on significant legislative change will require 60 votes in the Senate where the chamber is currently split at 50 seats by each party. Furthermore, you have some conservative Democrats like Joe Manchin from West Virginia who are unlikely to go along with radical change.

So, the market doesn't see much to worry about this year.

However, concerns may arise as to how long the Fed can maintain its ultra-accommodative monetary policy. Inflation could and should pick up, especially with a weak US dollar that causes import prices to increase and rising commodity prices. Interest rates in the face of record fiscal deficits could rise causing a steeper yield curve as liquidity is unwound.

An additional concern is whether the Coronavirus will really be gone. What if it mutates to a strain that isn't controlled by today's vaccine? Or, worse yet, what if we find that after some time the vaccines have some unforeseen side effects? An Agent Orange reaction might occur.

Current Market

So, with this as a background, let's look at what has been happening in the stock market. As I said, the economy is doing well. Globally, the manufacturing PMI's for December were 60.7 in the US, with new orders even better at 67.9. Europe was at 55.2 and China 51.9. (Anything over 50 signals growth). Not surprisingly, consumer spending on tech hardware and software rose 32.8% in the first ten months of 2020 to a record high. But none of this should come as a surprise. Coming out of a recession there is pent up demand that gets released, especially if the government sends you a free check. Manufacturing has to go into overdrive to keep up with this demand and to rebuild depleted inventories. So, production actually increases faster than final sales initially. However, one has to anticipate pent up demand being satisfied and inventories being restocked which will lead to a slowdown. This is usually about twelve-month cycle and will hopefully be offset somewhat by a recovery in the service sector as the COVID-19 vaccine allows for travel and entertainment.

All of this is good news relative to where we have been. But, when translating it to earnings we won't get back to where we were in 2019. Right now, earnings growth for last year only shows improvement with Q1 - 15.4%; Q2 -32.3%; Q3 -8.2%; Q4 -6.7% est.. For last year earnings for the S&P 500 are estimated to be $136 while forecasts anticipate $168 in 2021 and $196 in 2022, although some of the benefits of government spending will be given back through tax increases in '22.

This leaves the S&P 500 trading at 22.9X forward earnings and at 2.54X revenues which exceeds the "tech bubble" of 1.88X in Q2 of 2000. Right now, 52.9% of the S&P companies trade at over 20x earnings. Bottom line, the market is far from cheap which would appear to limit its upside.

However, as I have pointed out in the past, there is a disparity between the more economically sensitive value stocks and the disruptive technology and stay at home growth companies. So, instead of the market correcting, you could see a rotation from growth to value and in fact, that is exactly what we have experienced.

What is behind this? Well, for sure the overall valuation level of the market is due to the Federal Reserve's liquidity policy. There is an enormous amount of money around and the economy is not yet fully taking advantage of it with the services industries still shut down. In fact, the reaction to the Covid virus has left a record $4.6 trillion sitting in savings accounts and money market funds.

But there has been a subtle change. On August 4th the yield on the ten year US Treasury note bottomed at .52% and has now risen 63bps to 1.15%. Interestingly, we saw a peak in the relative performance of growth over value on August 28th, with many technology and FANG stocks spiking to highs at the end of the month only to be followed by lower prices as the market made new highs. Conversely, value companies showed extraordinary gains in November after the US elections on the promise of more fiscal economic stimulus. Fundamentally, this makes sense. The performance of growth stocks is highly dependent on the discount rate. Without getting too technical, valuation or price earnings ratios move higher when interest rates decline, and conversely, when they rise as has happened since the end of August. For Value stocks, earnings generally improve as interest rates move higher. For banks which are one of the largest components of value the correlation should be obvious as higher rates make lending more profitable. For others, rising rates usually correspond with higher inflation, which equates to better pricing power by economically sensitive companies.

The question which is still unanswered is whether this shift will continue. Although this is currently undetermined, there are signs that this may be more secular than just transitional. Although bond yields have risen, they are still extremely low by historical standards after a forty year bull market for bonds. Meanwhile, the new regime in Washington has an agenda focused on stimulation and increased deficit spending. Furthermore, the US dollar is declining, which will put upward pressure on import prices. Commodities are also increasing supported by the strength of housing and the emphasis on electrification of autos and solar and wind power, Biden's Green New Deal. Stimulus checks on top of $4.6trillion in savings could also put pressure on consumer goods prices which may also face pressure from rising costs and higher taxes. And finally, the trend to reshore manufacturing will add costs.

Conclusion

So, higher taxes and other major Democratic initiatives will be a 2022 problem while economic progress in the second half of this year might start to unwind some of today's bullish market under pinning. Although higher interest rates will initially be tolerated as they will be considered a good sign of economic recovery, they should also change the complexion of the market in favour of the more economically sensitive value companies.

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