2021 SPRING INVESTMENT OUTLOOK

Many of the trends in place in the opening months of 2021 are similar to those which persisted as last year came to a close. The Covid-19 virus still dominates the headlines and is one key variable in setting a baseline for discussions in Washington as well as dictating how corporate America and U.S. consumers behave. Economic growth continues the broad recovery begun in 2020's third quarter which is helping to gradually reduce the unemployment rate which now stands at 6.2%, a dramatic improvement from the 14.8% peak reached last April but still above the pre-Covid low of 3.5% one year ago.

Much of the economic improvement continues to be driven by government policy, both fiscal and monetary. On the fiscal front, the recent $1.9 trillion Covid relief bill, dubbed the American Rescue Plan, doubles down on 2020's $2.2 trillion CARES Act plus an additional $1.4 trillion of other spending measures passed last year. Political debate will soon begin on a new aid package and infrastructure deal with an estimated price tag of some $3 trillion which would enhance already robust growth prospects. Meanwhile, Federal Reserve Bank Chair Jay Powell has stated the central bank's clear intention to keep its benchmark lending rate at the same 0-0.25% range, where it has been for the past twelve months, through 2023. It also committed to continue buying $120 billion per month of Treasury and mortgage backed securities, supporting those markets and keeping downward pressure on interest rates.

The first vaccine in the U.S. was given in December and the pace of inoculations has picked up dramatically since then with President Biden fulfilling his pledge to administer 100 million doses in his first 100 days in office, well ahead of schedule. Positive news on the vaccine front coupled with warmer spring weather throughout much of the country is enabling states to ease restrictions and allowing many hard hit service sector industries to begin recovery. These trends will likely gain momentum as spring turns into summer and the vaccine rollout continues. The president has said that vaccines will be made available to nearly all adult Americans by May which is an achievable target and promises a more normal summer than many thought possible only a few short months ago.

Over the long term, and other things being equal, the trajectory of the stock market closely follows the path of corporate earnings. On this front, there has been reason for optimism in the year's first quarter. When the year began, Wall Street estimated that aggregate S&P 500 earnings would grow by over 20% and eclipse the record level achieved in 2019. Given the better than expected news regarding the progress in combating the virus and the additional stimulus out of Washington, near term prospects for corporate America look even better today. Current estimates now call for S&P 500 earnings to advance by over 25% and many investors believe that upward revisions may drive that figure higher as the year unfolds. Whether that translates into additional gains for stock market investors remains to be seen as a good deal of optimism is already priced into the stock market. The current forward price/earnings ratio of 21.8x is well above the five year trend line average of 17.9x. A confluence of factors has contributed to investors' enthusiasm including record low short term interest rates, momentum traders and the fear of missing out, the rise of new speculators who are using stimulus money and social media to drive their trading process, and popular investing trends like the use of special purpose acquisition companies (SPACs) and glitzy trading apps which glamorize the investment process. For these and other reasons, the popular market indices have continued their advance year-to-date as noted below.

Equity Markets – 3/22/21

	Index Price Level	2021 YTD Total Return
Dow 30 Industrials	32,731	7.5%
S&P 500	3,941	5.3%
NASDAQ Composite	13,378	4.0%
MSCI All Country World Index ex-USA	340	4.6%

Outlook

The sharp economic rebound that began in last year's third quarter is expected to continue in the coming months. The root cause of the current crisis has been a health care issue and the news in that regard is unquestionably improving with cases, hospitalizations and fatalities from Covid-19 falling dramatically. These positive trends should show continued progress as more Americans are vaccinated. As this occurs, many parts of the economy which have been shuttered for much of the past year will reopen allowing consumers, who are flush with cash, to satisfy their pent up demand. This combined with ongoing stimulus spending are the primary reasons that forecasts for economic growth have increased since the year began. The intergovernmental Organisation for Economic Co-operation and Development recently upped its forecast for global growth in 2021 to 5.6% from 4.2% previously. It now believes the U.S. economy will expand 6.5% in 2021 and another 4.0% in 2022. If that 2021 target is achieved, it will mark the fastest full year rate of growth since 1984 when the U.S. economy expanded 7.2%. Such an expansion can be expected to gradually bring down the unemployment rate and allow the approximately 9.5 million people who are not employed today, but were one year ago, to return to work.

As a percentage of GDP, the U.S. has spent far more than any other major country on relief efforts and so it is expected to lead the global recovery. In fact, for the first time since 2005 the U.S. is expected to be a bigger contributor to global growth than China. U.S. stimulus efforts have been debt financed with the federal budget deficit in 2020 reaching $3.1 trillion or over 15% of GDP, the largest percentage since 1945. Prior to the American Rescue Plan being passed, estimates for the current year called for a deficit of $2.3 trillion. Depending on the timing of when the Rescue Plan money is spent, this year's deficit may exceed $4 trillion. Not surprisingly, the added supply of Treasury bonds coupled with the fear of rising inflation tied to injecting all this money into the system has pushed longer term interest rates higher. Ten year U.S. Treasury yields have risen substantially year-to-date increasing from 0.92% to 1.68% currently. Stock markets have thus far taken the upward movement in rates in stride but this bears watching; if rates continue to trend higher, investor concern may translate into lower equity valuations.

Fed Chair Powell has been actively jawboning interest rates lower by trying to convince investors that the Fed is prepared to keep its benchmark lending rate low for years. Meanwhile, he simultaneously has offered reassurances that the central bank is prepared to act should inflation return sooner than expected. This extremely dovish policy has certainly been helpful to get the economy back on track but it has also led to many unintended consequences including dramatic increases in government debt, rising asset prices which exacerbates inequality, and misallocation of resources due to the artificially low cost of capital. It also creates the very difficult challenge of how and when to remove the extraordinary government support without negatively affecting the real economy and financial markets. It remains to be seen if this can be done effectively.

Sustained low rates are a global phenomenon and therefore the explosion of debt has occurred in most parts of the world. According to the Institute of International Finance, global debt soared to a new record high of $281 trillion in 2020. As a percentage of GDP, this ratio also hit a record high of 355%, up from approximately 300% ten years ago and up 35 percentage points in the last year alone. As noted above, this easy access to credit encourages capital to be misallocated. For instance, financially weaker companies that otherwise might go bankrupt are kept alive which hurts overall productivity and holds back economic growth. This is one reason why the World Bank recently lowered its projection of global growth to 1.9% per year between 2020-2029, down from its previous estimate of 2.1% and compared to 2.5% over the previous decade.

Despite this tempered longer term outlook for global growth, near term prospects for the domestic economy are solid as noted previously. This growth, coupled with price comparisons to year ago levels when the pandemic was in its early stages, will lead to higher inflation readings in the coming months. Costs of most commodities have increased notably versus one year ago. As one example, the current Brent crude oil price of $64 is up from the mid $20s twelve months ago and up over 30% in 2021. Company management teams have indicated that they intend to pass a portion of these rising costs along to consumers via higher selling prices. Money supply growth may also contribute to rising inflationary pressures. M2 money supply grew by over 25% in 2020, the largest annual increase since 1943, and it is predicted to increase by over 10% this year. While much of that money has not found its way into the economy yet due to virus lockdowns, that will change as vaccines become more widely available, potentially creating a mismatch between supply and demand which could lead to rising prices.

The banking sector could also be an additional source of capital as the economy emerges from virus era lockdowns. According to Fed data, the top twenty-five banks in the U.S. currently have 45.7% of their assets in loans and leases, down from 54.1% one year ago. Total bank deposits have increased approximately $3 trillion versus one year ago while corporations are sitting on over $2 trillion in cash, a record level. A portion of these funds is likely to leak into the economy over the course of 2021. This would enhance intermediate term growth prospects and may add fuel to near term inflationary pressures.

Geopolitics remains an ongoing issue highlighted by recent cyberattacks against the U.S. reportedly perpetrated by Russia and China. Many political historians suggest that a new "cold war" mentality exists today but rather than nuclear warfare being the main risk, cyberwarfare is the endgame today. This will likely increase in importance in the coming years as those countries face increasing internal pressures including declining working age populations, rising debt levels and lower productivity growth. History suggests that nations in that position may resort to finding external scapegoats, increasing the risk of rising geopolitical tensions in the coming years.

Investment Conclusions

As always, there are several crosscurrents in the current investment landscape. Improving news on the health front is encouraging and suggests that a return to more normal conditions by the fall months is a reasonable expectation. Unprecedented fiscal and monetary support will provide a solid underpinning for the economy for the next year and perhaps longer if an infrastructure deal is passed later this year. It remains to be seen, however, how successful the U.S. government will be in transitioning back to a more market driven economy as stimulus measures must eventually be withdrawn. As governments in Europe, Japan and China have found, removing policy support is incredibly difficult to do without causing unsettling disruptions to their economies and capital markets. Endless government spending is exacerbating the global debt problem, which ironically curtails longer term economic growth, the exact opposite of stated policy goals. Meanwhile, extraordinary monetary support is worsening wealth inequality in this country by artificially inflating the prices of the assets such as stocks, bonds, real estate and private investments, which are predominantly held by a minority of Americans.

Many of those assets are trading at valuation metrics that put them among the most richly valued times in their history. While such measures are very poor at predicting short term market moves, they are historically very accurate predictors of longer term investment returns. Therefore, while stocks are expected to provide acceptable risk adjusted returns going forward, those returns are likely to fall short of historical averages so investors would be wise to temper their expectations.

Nevertheless, we continue to strongly recommend that investors maintain a long term investment horizon focusing on financially sound companies with solid growth prospects and run by able management teams. A buy and hold approach that allows those securities to compound on behalf of patient investors will remain a critical way to preserve and growth wealth over the long term.

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