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# Update on the Economy and Investment Markets

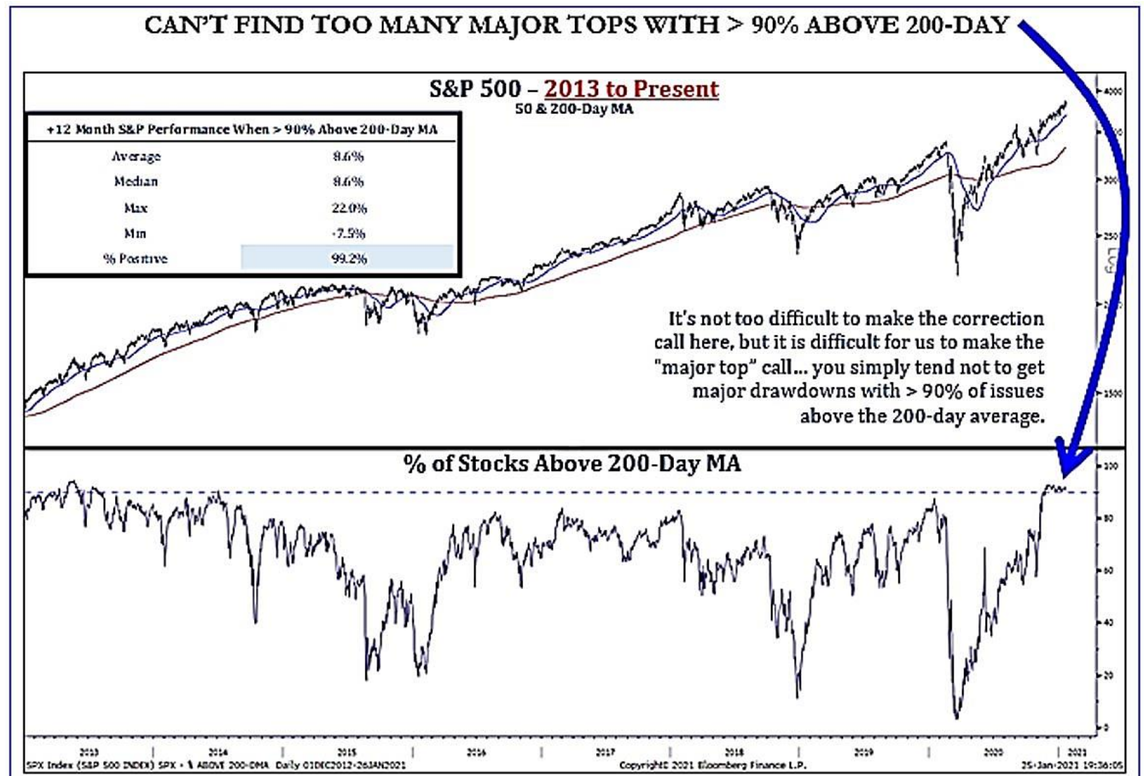
Welcome to the Stearns Financial *Fireside Chat.*

Rarely have we seen more in terms of contrasting trends than during these past few weeks. In an attempt to make sense of these competing news items and how each may impact the market, we will focus this week on the good, the bad and the unknown – that is, the data points whose impact will be judged by the benefit of hindsight.

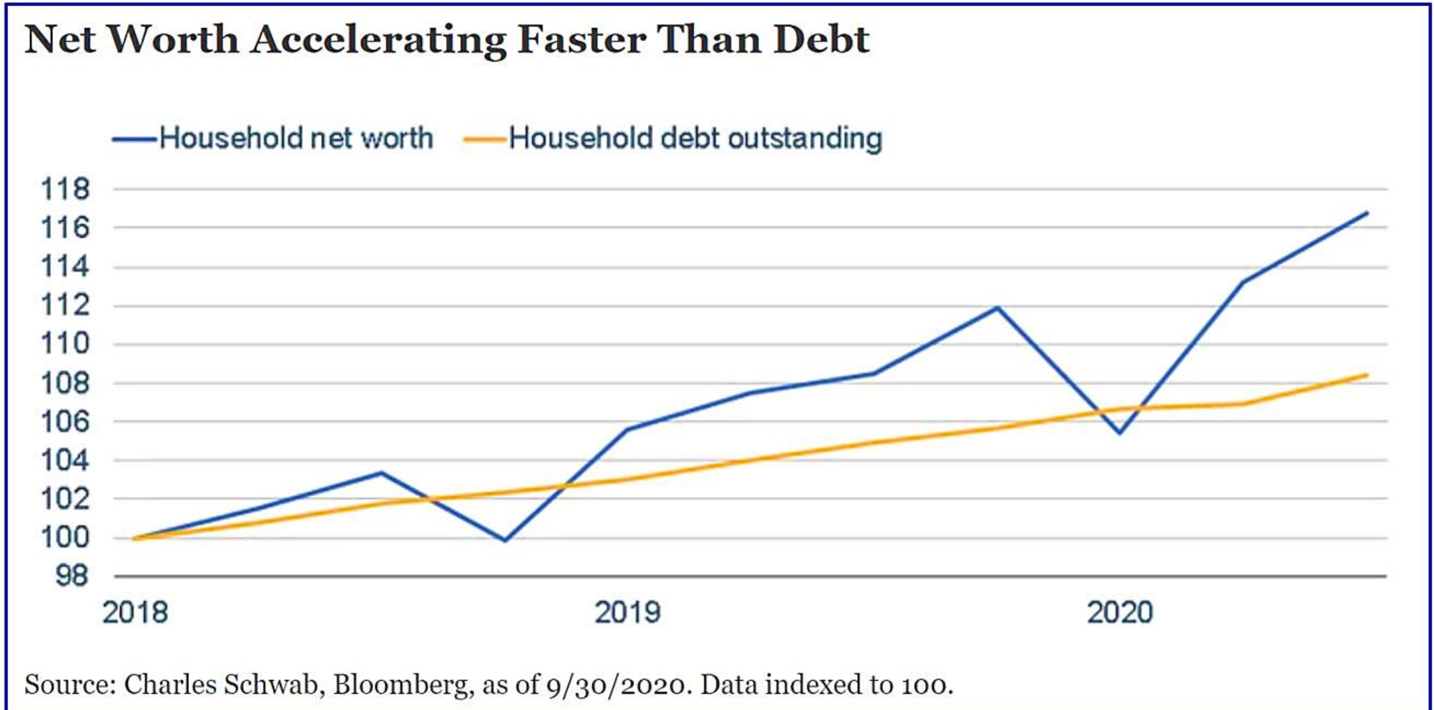
## The Good

The good news alone accounts for a bevy of topics and starts with an improving economy, both domestically and around the world as consumers adapt to their new reality and get a handle on the virus. Better vaccine distribution should ultimately lead to herd immunity, returning life back to some semblance of normalcy by year end, if not sooner.

Naturally, an improved economy will yield better projected corporate earnings. Coupled with continuing accommodative fiscal and monetary policy and a calmer political environment, we can expect a less stressful 2021, though the bar has been set pretty low following 2020.The markets showed increasing volatility this past week with much talk of a bubble that is close to bursting. While we examine the below indicators of a "bubblicious" U.S. stock market, Strategas (a leading research entity) reminds us that there is more going on in this pandemic endgame than meets the eye. Because the broad participation of stocks moving up rarely coincides with a major stock market top, we still believe a run-of-the-mill 5-10% correction, which usually occurs several times a year, is more likely in the near-term.



Other good news surrounds the consumer who appears to be in good shape economically, with personal debt at reasonable levels and net worth higher following a forced economic shutdown that shuttered everything from travel and leisure spending to gas consumption. Obviously, there are many consumers who have not fared as well (sadly, a tale of two consumers), who are currently struggling with job losses and failing businesses. However, as we have analyzed in previous *Chats*, the segment of the population that is currently faring well is bubbling over with pent-up demand, a trend we feel will begin the liftoff to economic recovery.




## The Bad

In the bad, or potentially bad, news column, there remain a number of elevated risks in key areas:

1) The pandemic surge continues, though it is cooling down a bit as the numbers of Americans receiving vaccines grow. With that said, newly found strains of COVID-19 may create more havoc and may not respond as well to the vaccines currently available.
2) In addition, it's unclear how long it will take consumers to reignite the economy due to fear of contracting the virus before the "all clear" sign is fully raised.
3) The new razor thin margins in the U.S. senate may wreak havoc on our legislative process. Unfortunately, filibuster is likely with every remotely controversial piece of legislation, extending the timeline required for needed action to jump start the economy.
4) The risk of higher taxes may offset the potential higher earnings companies will experience as a result of the "digital pivot" and cost cutting measures they undertook due to the pandemic. [CLICK HERE to view our recent "Over the Horizon" Live Chat session for more information on our scenarios for 2021 and 2022 tax changes.]
5) Our politically divided country will not likely reconcile overnight. Will the quiet after the storming of the capitol continue throughout the country?

6) How successful will our major trading partners around the world (who in some cases are key to the U.S. economic recovery), be in managing their own vaccine rollouts? [See the supply chain general concerns below.]
7) Margin debt, mentioned in our 2021 forecast, continues to escalate, suggesting a sense of irrational exuberance on the part of some investors. While it's true that the prudent use of margin debt can be a good thing, using it for speculative investing is generally not. We suspect there are many speculators (we won't call them investors) who are playing the momentum stock game, believing that what goes up should go up more, and using borrowed money to do it. Historically speaking, this behavior does not generally end well.

Concentrated volatility in certain so-called "meme stocks" such as GameStop Corp (GME) and AMC Entertainment Holdings (AMC) made news this week as a new wave of populist retail investors organized via social media, demonstrating their market influence. The extreme volatility ultimately caused certain brokerage firms, most notably Robinhood, to restrict trading in certain stocks. We anticipate this story will continue to play out in the

markets over the coming days and weeks. Regulators are reviewing the situation, and we will continue to monitor. https://www.cnbc.com/2021/01/29/sec-reviewing-recent-trading-volatility-amid-gamestop-frenzy-vows-to-protect-retail-investors.html

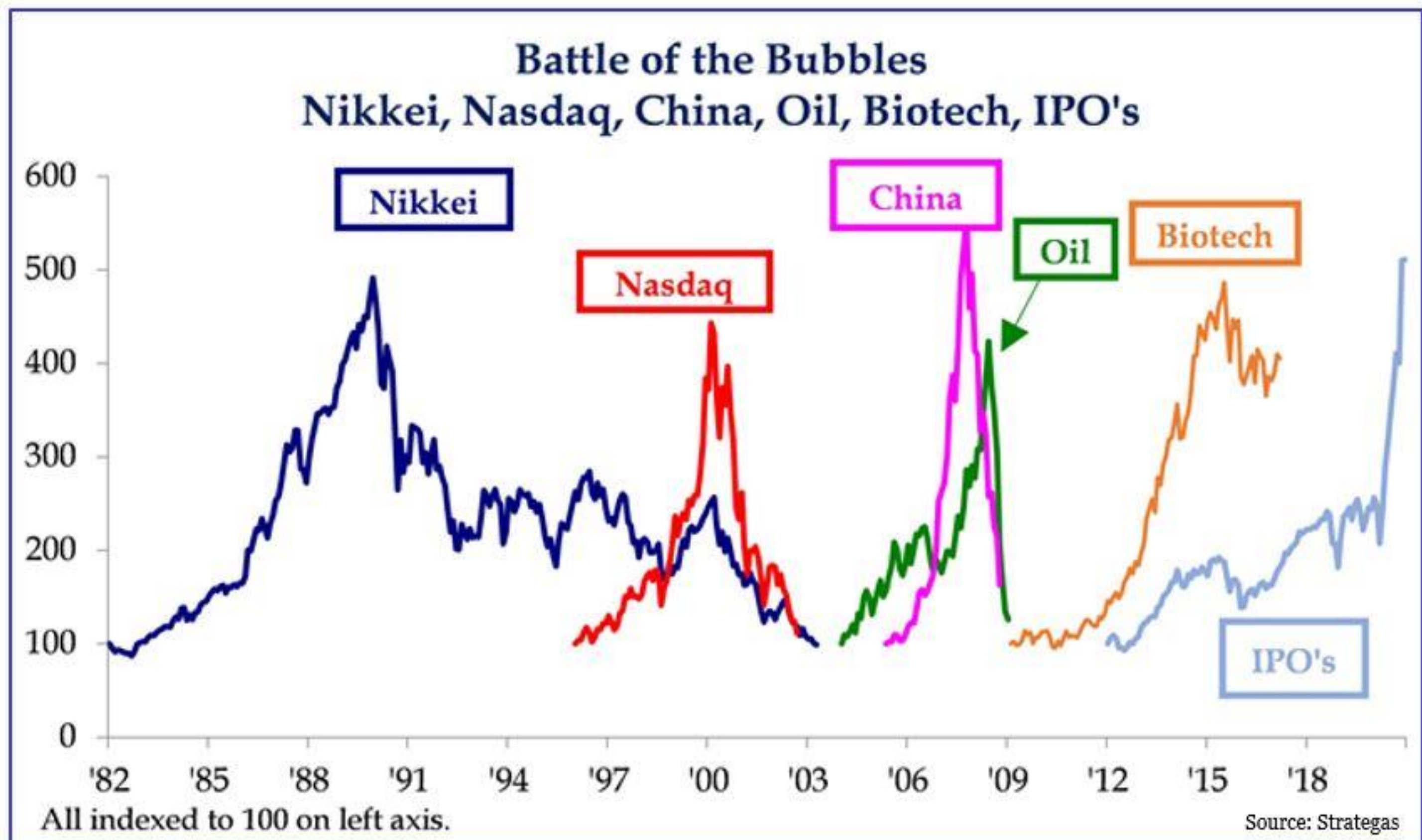
8) And finally, as the chart above indicates, the elevated stock market compared to GDP data point is exhibit A in the argument that we are, in fact, experiencing a broad stock market bubble. Even if this indicator is adjusted for an above average rebound due to the opening up of the economy, there are plenty of other risks, outlined above, that could derail the stock market or the economy.

## The Unknown

The "time will tell" news is that investors have already bid up stock prices on expectations of better growth, easing economic restrictions, improved earnings and continuing policy support. While we are optimistic (outlined in our Ten Forecasts for 2021 *Fireside Chat*) that normalcy will return to the economy by Labor Day, we find it hard to make a case that stock valuations can increase much more from here. This suggests more near-term caution. Because low interest rates are frequently cited as support for current stock valuations, market participants (and SFG) will be closely monitoring Federal Reserve guidance and expectations around inflation.

The Big Five U.S. stocks that have powered broad indices higher in recent years have begun to show a little more life in 2021 after correcting modestly in 2020 and then trading sideways following the major vaccine announcements. Time will tell if the Big Five can move higher near-term given their current valuations and the headwinds they face in terms of regulation and potentially higher taxes. Keep in mind that since technology has an outsized impact on the S&P 500 (making up more than 30% of market cap), its positive or negative performance can easily mask trends in other market sectors.

Source: Charles Schwab, Bloomberg, as of 1/22/2021. Data indexed to 100. Big 5 stocks (thru 1/7/2021) include Alphabet, Amazon, Apple, Facebook, and Microsoft. Big 5 stocks (as of 1/8/2021) include Alphabet, Amazon, Apple, Microsoft, and Tesla.




**SFG's Take:** Parts of the U.S. stock market are closer to bubble territory, while others remain fairly valued or even undervalued. As the "Battle of the Bubbles" chart shows on the following page, the Initial Public offering (IPO) market is clearly in bubble territory.

We expect overall U.S. equity returns to be relatively modest in 2021, trailing the expected economic recovery and higher corporate earnings forecasts, given much of these expectations are already reflected in current stock valuations. We also believe we will continue to see an uneven rotation away from growth, large cap and U.S. stocks toward value, small cap and international stocks.

## COVID-19 Update

Several of our key research services have been digging deep into the problems surrounding U.S. company supply chains both domestically and around the world during this most recent COVID-19 surge. While our focus is on the impact of supply chains to corporate earnings (critical for many companies to reduce their stretched valuations), it turns out this issue also has ramifications for vaccine manufacturing.

For example, AstraZeneca's European crisis, got markedly worse this week when it informed EU leaders that its vaccine shipments this quarter would be 60% lower than contractually promised. The company didn't give the EU any evidence to back up its vague claim of manufacturing difficulties, creating the impression that it might have actually sold the promised doses outside the EU at higher prices. Now officials are calling for export controls. Politico

## Key Points to Consider

- **Manufacturing remains a bright spot for the U.S. economy.** The headline ISM manufacturing survey increased from 57.5 in November to 60.7 in December, one of the highest readings in decades. While many U.S. service sectors remain under pressure, manufacturing indicators continue to look strong.
- **China Watch** – President Xi Jinping gave a virtual-Davos speech this week to world leaders in which he warned the U.S. (though not by name) to stop being so confrontational with China. Xi: "History and reality have made it clear time and again that the misguided approach of antagonism and confrontation – be it in the form of a cold war, hot war, trade war or tech war – will eventually hurt all countries' interest and undermine everyone's well-being." Axios

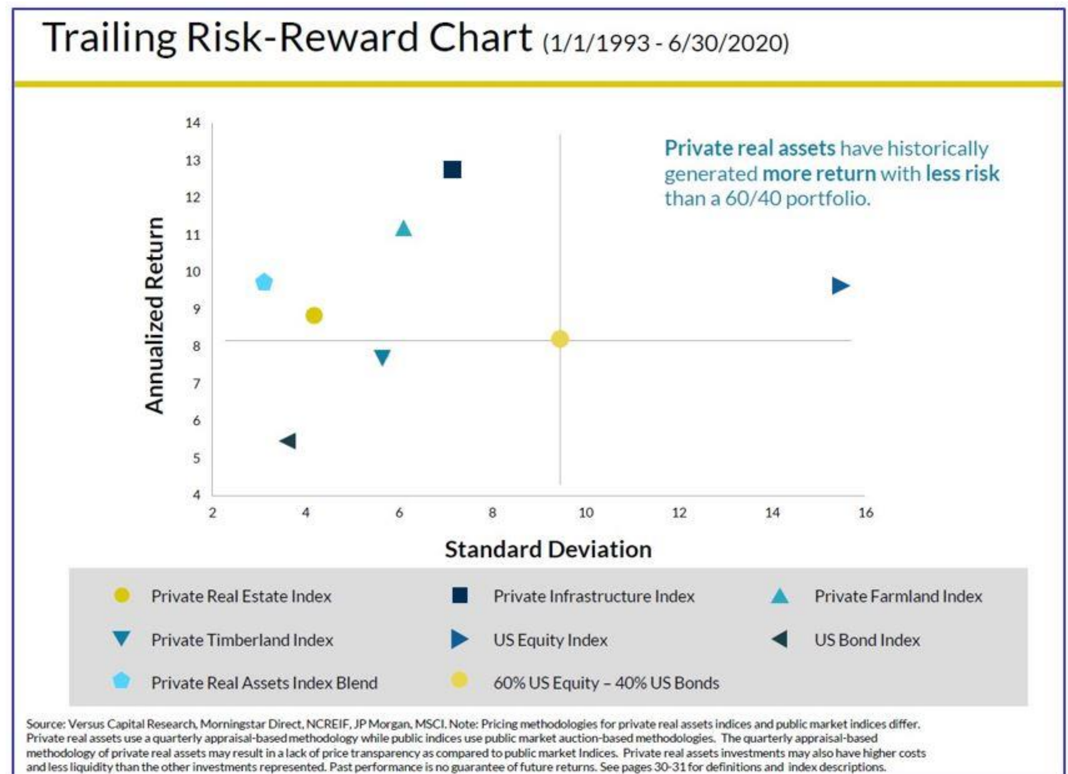
## Frequently Asked Questions

**Q: In your Ten Forecasts for 2021, you mention some interesting alternative assets that SFG is using or contemplating. Real estate is among the options – how will real estate do in the COVID-19 endgame and aftermath?**

**A: Investment real estate comes in many shapes and sizes. Even similar properties across the street from one another can have different operating results and ultimate returns.**

We have been tracking a number of property types from multi-family to office, to storage to retail, throughout the pandemic. High grade properties (class "A") have maintained exceptional occupancy rates. Even class A retail has bounced back very quickly in the latter half of 2020. Lower quality real estate has experienced much more volatility, in part due to the fact the pandemic has been more punishing in general for the lower income tenants that occupy lower quality real estate.

**We believe our real estate holdings in the next three to five years will do fine in the majority of post-COVID-19 economic scenarios we envision.**




Most real estate that SFG has been involved with over multiple decades is higher quality and has an income component and a growth component. The combination of the two (known as "total return")

creates good return over inflation. Real estate can often be a good diversifier to other growth and income assets, including traditional stocks and bonds.

For the most part we prefer to participate in diversified funds where the risk of one or two properties underperforming impacting the overall total return is lessened.

Most of our portfolios already have a modest allocation to traditional real estate and real assets (infrastructure, timber and farmland). The Trailing Risk-Reward chart highlights the benefits of diversifying into these market sectors. For those clients who have a higher income or net worth and can qualify for private investments (three levels – accredited investors, qualified clients and qualified purchasers – see definitions at the end of the FAQ section), we can consider additional real estate options that often have higher levels of risk (and debt), but often have higher total return potential.

SFG has considerable experience with single family rental homes and have found them to sometimes work out well, and other times to be uneven in their cash flow and appreciation over time. Sometimes difficult tenants and unexpected repairs or maintenance costs create volatile cash flows. Other times, changes in the surrounding neighborhood create headwinds for cash flow and growth. Higher risk demands higher returns, so we encourage our clients to carefully analyze individual properties – SFG can help you in the risk/reward analysis.

We generally exclude second homes at the beach or mountains from investment real estate calculations given that wear and tear coupled with ongoing maintenance costs often offset some or all the appreciation in a property over time. Some of our clients have used Airbnb or similar services to rent their second homes, which has created positive cash flow to offset costs. In some cases, such practices have created enough positive cash flow to qualify the property as an "income property."

The opportunities are wider for higher income or higher net worth investors. Note, however, there is a very wide spectrum of risk across investments that accredited investors, qualified clients or qualified purchasers can participate in. Let us know if you would like to discuss the pros and cons of various types of real estate as an addition to your portfolio.

**Definitions**

Accredited Investor – a person must have an annual income exceeding $200,000 ($300,000 for joint income) for the last two years with the expectation of earning the same or a higher income in the current year. An individual must have earned income above the thresholds either alone or with a spouse over the last two years. The income test cannot be satisfied by showing one year of an individual's income and the next two years of joint income with a spouse. A person is also considered an accredited investor if they have a net worth, excluding their home, exceeding $1 million, either individually or jointly with their spouse.

Qualified Client – an individual or entity that has $1 million or more in assets under management with the fund's investment adviser following their investment in the fund and has a net worth of $2.1 million prior to the investment in the fund (excluding the value of his or her primary residence).

Qualified Purchaser – an individual or a family-owned business that owns $5 million or more in investments. The term "investments" shouldn't include a primary residence or any property used for business.

The term "investments" is fairly broad here and includes stocks, bonds, futures contracts, cash and cash equivalents, real estate, financial contracts and other alternative assets held for investment purposes, either public or private.

## Summary

SFG is balancing numerous opportunities and threats in our portfolios, customized to our client's unique circumstances. We are being more cautious as parts of the U.S. stock market have exhibited irrational exuberance in response to positive developments in COVID-19 vaccines.

In growth portfolios, we are emphasizing a variety of short- and intermediate-term asset classes and trends that we believe have favorable forward-looking risk/reward relationships.

In growth and income portfolios, we are taking more steps to be defensive, while still striving for positive real returns over inflation.

**Our COVID-19 endgame investing approach can be summed up by six themes:**

- Diversification with a balance of offensive and defensive measures, depending on the desired risk tolerance of our clients,
- Underweighting, or avoiding areas of higher future concern,
- A focus on higher-quality investment themes,
- Identifying and implementing buying opportunities that may be appropriate for more growth-oriented portfolios,
- A more defensive stance using different portfolio tools for more conservative growth and income portfolios, and
- Utilizing select alternatives to traditional bonds and stocks.

~ Dax, Dennis, Glenn, Jason, John and PJ
*(the SFG Investment Committee)*

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