STEWART CAPITAL

Market Commentary – Fourth Quarter 2020

Malcolm Polley, CFA, President and Chief Investment Officer

In many respects and from an economic, financial and geopolitical standpoint, we are in uncharted waters as we enter 2021. It all looked so dismal in the spring of 2020. All but *essential* businesses were shuttered, people laid off, markets crashed and interest rates were cut to zero. All looked lost. Any hopes of achieving our modest expectations for the year were rapidly slipping away. . . and then they didn't.

Myopic. . . That's right; last year we did say that myopia or nearsightedness is usually the downfall of market pundits and participants. We get so hung up on the recent past, specific data points or the potential of near-term events that we fail to put into context information received and often reach faulty conclusions. Yet who could have predicted an announcement out of Wuhan, China that people were getting sick and dying from a mysterious flu-like virus would lead to a global economic shutdown and the greatest global economic shock in history?

We had been concerned about the possibility of a slowdown in consumer spending, but no one could have foreseen a total spending collapse – even one mandated by the government!

While economic activity around the world collapsed (down 31.4% in the United States during the second quarter of 2020, according to *Yardeni Research Morning Briefing*, January 4, 2020, "Three Front Man"), the recovery – particularly that in the United States has been nothing short of amazing. Talk about pent-up demand! Q3 GDP grew 33% and it is expected to grow (per the Atlanta Fed GDP Now forecast) by an additional 8.6% in Q4 (as of January 4, 2021). This should peg 2020 full-year GDP at a very respectable two percent or higher.

The Economy

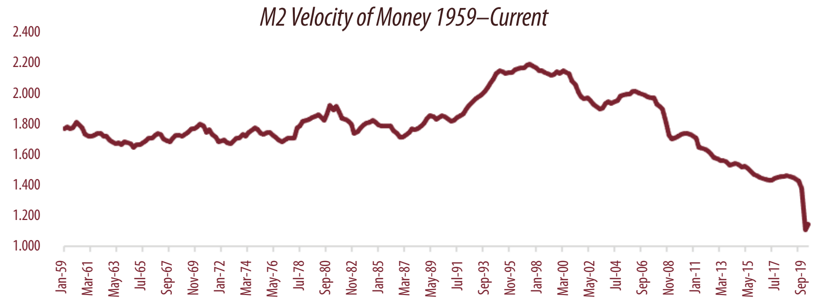
With a new administration comes the intent to put in place spending proposals that are intended to get the economy going and show everyone that *this administration means business.* The incoming Biden team should be no different.

Even though any potential new spending could bust the budget, it will be nothing compared to the post-pandemic stimuli having been injected and expected to be injected in the current year.

With the passing of the recent $900 billion stimulus proposal, total pandemic stimuli are now greater than $3.5 trillion. (Source: "5 Breathtaking Numbers Reveal The Unsettling Cost Of Stimulus" by Rob Berger, *Forbes*, October 18, 2020). Put into context, total US GDP at the end of Q1 2020 was $21.56 trillion, so stimulus spending represented more than 16% of pre-pandemic GDP and more than 20% of trough pandemic GDP (Q2 GDP of $17.302 trillion – Source: *Bloomberg Professional*). This current monetary and fiscal helicopter money policy has caused more than a few people to talk with great concern about the prospect for inflation, a concern we do not share – for now.

So why aren't we currently concerned about inflation? There are a couple of overriding issues that have worked in concert to hold down inflation in the face of both accelerated spending and free-flowing monetary policy actions. The first we visited in last year's end-of-year commentary and have spoken about at length at client events over the past several years: Baby Boomers. Once the largest generation in history, they are past their spending peak and are continuing to slow spending.

Figure 1



Source: Federal Reserve Bank of St Louis FRED Database

Even though Millennials are now the largest generation in history and rapidly increasing their expenditures, because they are not as large a demographic group as the Boomers relative to the size of the total population, they cannot fully offset the decline in Boomer spending.

The second issue we have also talked about in the past and believe will likely be the cause of renewed inflation is the velocity of money.

The velocity of money is the speed with which a dollar changes hands over the course of a given time period. Put another way, the velocity of money is the number of times one dollar is spent to buy goods and services per unit of time, and we are at or near all-time lows (See Figure 1).

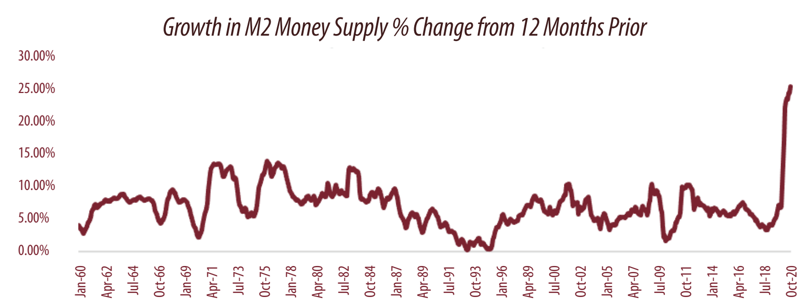
Velocity collapsed right along with economic activity in the summer of 2020 and has not recovered, which is surprising given the amount of stimulus that went to the consumer. However, it does prove a point we have been making for some time. If you give money to a demographic that already isn't spending money, they are simply going to save more (or reduce outstanding debts). While it has increased a very modest amount from a low of 1.1X in Q2 to 1.147X in Q3 (Q4 data is not available yet), it is a long distance from its long-term average of nearly 1.8X.

So why are we worried that velocity of money might likely be the cause of renewed inflation? Because that's what the data shows, the percent change in M2 money supply from 12 months prior going back to 1960 (See Figure 2). Those of us that are old enough (Baby Boomers) remember that whenever you got an increase in money supply, inflation ensued. This is because while there was some volatility in the velocity data, it largely stayed bounded in a range from 1.7 to 1.85X. Ergo, with velocity staying constant, when you get an upward spike in money supply you get inflation.

We can also see why the ultra-tight monetary policies of the early 1990s didn't cause deflation as we had a rise in the velocity of money as an offset. Since its peak in 1998, the velocity of money has been steadily declining. Can it go lower? Certainly, but given that we are already more than three standard deviations from the mean (which includes 99% of all possible results), how much lower can it really go?

Unemployment that was low heading into the pandemic lead recession, and spiked significantly because of the

Figure 2



Source: Federal Reserve Bank of St Louis FRED Database

shutdowns. While the level of unemployed persons remains unacceptably high, we are encouraged by a few things. First, even though the additional pandemic unemployment payments discouraged some to look for work, the unemployment rate fell rather rapidly from a high of 14.7% in April to its current (November data from the Bureau of Labor Statistics) reading of 6.7%, a level that is close to being in the band considered full employment (4–6% unemployment), but remains dramatically above levels achieved at last cycle's peak unemployment (3.5%).

The other interesting thing is that total job openings never declined below the peak from the 2000–2007 expansion, and only modestly declined from the last cycle peak. In fact, job openings never fell much below 5 million (4.996 million) and have since rebounded aggressively to more than 6.6 million – a level that was not reached until more than five years after the end of the Great Recession.

The upshot? Barring negative events or shocks, the economy should be reasonably robust.

Interest Rates

We are at zero (on Fed Funds), so how low can it go? Answer, not much. Yes, we said last year that there wasn't much room for price movement within the bond sector and that total returns would be hard to come by that were in excess of coupon, and we were proved wrong. That said, the situation has only worsened as spreads continue to compress. While this has provided excess return for credit products (read non-government bonds), the extreme spread recoveries from the pandemic blowout in early March leave little room for return enhancement in 2021.

We have been following index yield, duration and maturity data over the past couple of years, as the situation is and has been a concern. One of the things we have noted is that YTW has been going down as duration and time to maturity have risen (See Figure 3). This can be directly attributed to massive refinancing activity by corporations that are taking advantage of the rate environment and the fact that investors looking for yield seem to be willing to pay anything and accept any rate to get it. On the downside, rates can't get much lower. Figure 3 is a look at bond indices from the standpoint of yield to worst (TYW), which we can think of as roughly akin to yield; duration, which allows investors to determine how much a bond's price will move with a one percent change in interest rates; and time to maturity (which is self-explanatory). A year ago, interest rates were, on average, about 1.2% higher than they are currently.

With the Federal Reserve reluctant to follow negative rate policy used by central banks in other parts of the world, there is limited appreciation potential remaining. As a result, the best that we can hope for is coupon-like (YTW-like) returns from bonds in the coming year. It also means that the potential for negative returns from bonds becomes an increasingly likely possibility.

Figure 3

	5-Jan-21			*17-Jan-20*		
Index/Security	YTW	Duration	Time to Maty	YTW	Duration	Time to Maty
Bloomberg Barclays US TR T-bills 1-3 Mo	0.08%	0.28	0.28	1.55%	0.16	0.16
Bloomberg Barclays 1-3 Yr US Gov't	0.13%	1.97	2.02	1.70%	1.9	1.97
Bloomberg Barclays 1-3 Yr US Gov't/Credit	0.22%	1.94	2.02	1.70%	1.9	1.97
Bloomberg Barclays US Corp 1-3 Yr	0.48%	1.85	2.01	2.02%	1.87	2.01
Bloomberg Barclays US Agg Intermediate	0.83%	3.58	4.4	2.07%	4.06	4.53
Bloomberg Barclays US MBS Index	1.24%	2.37	4.13	2.43%	4.16	4.84
Bloomberg Barclays US Agg	1.13%	6.25	8.34	2.23%	6.21	8.09
Bloomberg Barclays US Tsy	0.57%	7.27	8.53	1.73%	6.6	8.14
Bloomberg Barclays Global-Agg	0.83%	7.48	9.19	1.41%	7.26	8.96
Bloomberg Barclays US Agg Gov/Credit	1.08%	7.79	10.07	2.15%	7.05	9.44
Bloomberg Barclays Global Aggregate Corp	1.24%	7.43	9.85	2.15%	6.97	9.5
Bloomberg Barclays US Corp	1.77%	8.86	12.38	2.77%	8	11.58
Bloomberg Barclays US Agg Baa	2.06%	8.84	12.73	3.10%	8.1	12.11

Source: Bloomberg Professional

Market Overview

After looking like 2020 could be a total loss, the economy and markets turned on a dime, and ended the year quite strongly.

Broad equity markets ended with double-digit returns and bonds ended the year with mid-single-digit returns. We don't expect that to be repeated in 2021, as both equity and bond markets looked past immediate short-term, pandemic-related issues and focused on 2021, which we believed was the correct decision.

Unfortunately, as is often the case, markets tend to take the future to extremes in terms of its assumptions. We believe that may prove to be the case in 2021.

There was another issue that we think could come back to bite investors, and it shows up most readily in the disparity between market returns and value returns. That issue is how most indices are constructed. As we wrote in the summer of 2020, most equity market indices are market capitalization weighted. In other words, the larger the company is in market capitalization (number of shares outstanding multiplied by share price), the larger its representation in the index. For example, as of January 5, 2021, the total market capitalization of the top 100 companies in the S&P 500 (representing 20% of all companies in the index) was equal to 71% of the total market capitalization of the S&P 500. The largest names in the index, which tend to be growth names due to the outperformance of growth over value the past decade, are and have been driving index performance. This led to broad indices like the S&P 500 outperforming their value components by nearly ten percentage points! Looking at equity annual return data from Morningstar over the past 25 years, we note that the S&P 500 has only experienced a return differential of this magnitude one other time – the late 1990s. While we are not prescient enough to know if 2021 will look like 2000, we do not believe that this performance disparity can hold indefinitely – particularly when the average PE of the top 100 companies is more than 50 times earnings.

Fixed income returns, as we indicated previously, were also nicely positive. Like last year, due to the very low interest rate environment, most fixed income returns came from price appreciation. With interest rates as low as they are, and coupons being refinanced downward, we don't expect this relationship (price return outweighing coupon return) will change any time soon.

Outlook

Our outlook for the economic climate in 2021 is fairly constructive. Ongoing COVID surges and the time needed to ramp up and broadly distribute vaccinations will likely mean that the first half of the year's GDP should be less robust than the fourth quarter, and will likely be the low point for the full year. The second half of the year, however, could see a return to more normal economic behavior with the result that full-year GDP growth will likely be about two percent. We also expect that the unemployment situation will continue to improve, albeit at a markedly slower pace, as enhanced unemployment benefits tend to create a dis-incentive to look for work. However, many of the lower-paying service jobs that have been lost in the pandemic likely won't be back – as longer-term trends (working from home, business travel being replaced by virtual meetings, etc.) were accelerated into 2020.

We expect that the unemployment rate will likely get stuck in the low-to-mid six percent area with available jobs continuing to tick higher. This will be due to continued growth in skilled work, both service and manufacturing, as the transition to a knowledge-based economy accelerates. We should also see a continued decline in the available labor pool (those above age 15, not working and not looking for work) as the Boomer generation continues to retire.

We are more concerned about 2021 and its investment outlook than any year in our experienced history.

We are at a long-term macro, secular interest rate inflection point, and the new trend will likely be the wrong direction for those expecting anything approaching normal returns. We agree that rates will remain low for some time, but that simply means bond returns will likely be stuck in a range between zero and very low single-digit returns. The slope of the yield curve will determine how longer-dated bonds do, but any upward movement in the slope (longer-term rates moving higher) will mean negative returns for those longer-dated bonds.

Based on expectations for decent economic growth of around two percent and Fed Funds the should stay in its 0%–0.25% range through all of 2021 (and probably well into 2022), we think that the ten-year Treasury is likely to end 2021 near 1.5% with the thirty-year getting close to 2%. Assuming, at best, stable credit spreads, our expectations are for very low single-digit to low negative single-digit returns for bonds depending on length or portfolio maturity, meaning that bond returns should end the year well below normal.

Equities could have an *interesting* year. We believe that the significant disparity between performance of value and *other* stocks could be re-ordered as investors search for yield. (Value stocks are generally believed to be dividend-paying stocks, although that is not the definition we use.) While earnings, on a broad basis, could be pretty good (according to *Bloomberg Professional* analysts, who are expecting 22%+ growth in 2021 vs 2020 earnings), it seems to be more than well discounted with PE ratios in excess of 22X expected earnings ($166.61).

Expectations for 2022 S&P 500 earnings are around $191. Assuming that the multiple stays roughly where it is at around 22 times earnings, that would target the S&P 500 at roughly 4200. If we include the 1.57% dividend yield, then the total return for 2021 would be targeted at about 15%, resulting in an above average year. However, that assumes that a lot of things go right and, in a year, where there are very few fiscal or monetary policy options, it could prove to be overly optimistic.

A more likely scenario, in our mind, would see modest PE contraction and the S&P 500 would end the year at roughly 4027 for a return (dividends included) of about 9%—still not a bad year, but one that would be modestly below average.

Strategy Overview

Given that we believe on a broad basis that the downside risks outweigh the upside potential, keeping a close eye on the relationship between risk and return is vital.

Gauging appropriate valuation and purchase prices relative to risks has always been, and will always be, our primary focus. Linking investment decisions to something tangible like the cash-generating capabilities of a business or investment, and assigning a minimum acceptable rate of return to each decision, should add value. Elevated risks should translate into higher return requirements and lower valuations, all else equal.

Looking at investments, as would any rational person, helps us focus on those things that are important: return of and return on capital invested.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns in excess of our requirements, we jump. Over time, this should allow us to be well compensated for the decisions made. In our mind, the real risks are those not taken.