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January 2021 Market Commentary

In 2020, the stock market took investors for a wild ride through a pandemic. In the first quarter, the abrupt Coronavirus lockdown put an end to the longest bull market in history (11 years); in only 23 trading days, from February 19 to March 23, the S&P500 declined 34% from a peak of 3386 to 2237. This breath-taking sell-off was the most precipitous bear market on record; in fact, on March 12, the S&P500 declined 9.5% in one day!

On March 27, President Trump signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, transfusing a record $2.2 trillion into a bleeding economy in the form of relief checks, large company loans, small business payroll protection, and aid for hospitals and schools. This action was in concert with the Federal Reserve, which on March 15 had announced its own historic program. The Fed reduced its policy rate, Fed funds, from 1.5% to zero, and initiated an aggressive new Quantitative Easing (QE) program, including the purchase of Treasury bonds and mortgage-backed securities as necessary to support the economy. With this massive fiscal and monetary stimulus in place, the S&P500 climbed back to its February high of 3386 on August 18, confirming the start of a new bull market. This rally continued until year-end, and the S&P500 closed at 3756, up 18.4% for the year. From the low of 2237 on March 23, this represented an increase of 68% in only nine months!

To understand the magnitude and importance of the Fed's new QE program, we must look at its history. The Fed inaugurated QE in 2008, in response to the Great Financial Crisis. Over the next six years, the Fed purchased $3.6 trillion of bonds and mortgages, increasing its balance sheet to $4.5 trillion in early 2015. Then the Fed paused for three years until it finally gained enough confidence in the economy to start "tapering" its balance sheet, which declined to $3.8 trillion in early 2020. When Covid hit the economy, the Fed re-started QE, as noted above, and almost doubled its balance sheet to $7.4 trillion by year-end. When the Fed purchases bonds, it credits bank reserves, thus creating money in the financial system. To date, the Fed has "monetized" about 20% of total Treasury debt ($27 trillion).

Public policy experts raise red flags when a country's total national debt approaches its national output, known as GDP. In the US, the national debt has been growing faster than GDP for decades and recently surpassed it, in large part because of the pandemic. However, in a recent paper, former Treasury Secretary and Harvard economist Larry Summers argued that our national debt should be measured against national wealth (the present value of future GDP), not one year's GDP. On this basis, even after the CARES Act, the national debt is only 0.5% of

"Infinite Horizon GDP," and notably, the percentage has declined since peaking in 2014 at 0.7%. This analysis may explain why the bond market is so quiescent in the face of the recent onslaught of national debt, with the yield on 10YR Treasuries trading at only 1%. If Summers' analysis is correct, the rapid growth of the national debt is a political problem, not an economic one—the issue is how we pay for it, not whether we can afford it.

The historically low level of interest rates is a fundamental support for the stock market—interest rates are used to "discount" the projected stream of future corporate earnings to their current market value. In 2019, S&P500 earnings were reported at $165 per share; with a low "discount rate," the market valuation level reached 19 times. At the onset of the pandemic, earnings estimates for 2020 declined precipitously, to $120 per share. However, in the second half of 2020, fiscal and monetary stimulus fueled an astonishing rebound in earnings, setting the stage for expected earnings of $185 in 2021, more than 10% above the prior peak in 2019. Low interest rates and strong earnings growth continue to support a historically high market valuation level.

Low mortgage rates have also stoked housing demand and prices, contributing to increased consumer net worth to a record $130 trillion, more than 10% higher than its pre-pandemic level. A high consumer savings rate, pent-up demand, and a large labor pool provide ample economic firepower; only about half of the 22 million jobs lost in the pandemic have been replaced so far. Businesses are rebuilding inventories and buying new equipment to boost productivity. In fact, business investment levels are also higher than the pre-pandemic level. Last but not least, in late December, Congress enacted another $900 billion stimulus plan to supplement the CARES Act, and more legislative action may be forthcoming this year.

What are the risks to this outlook? Massive fiscal and monetary stimulus could generate inflation and higher interest rates…but at least initially, this would probably not concern the Fed, as inflation has been below their 2% target for years. The resurging Covid infection rate could slow economic activity again this year, especially if there are delays in vaccine distribution. In addition to the two approved vaccines, from Pfizer and Moderna, JNJ's clinical trial should be complete next month, and AstraZeneca's vaccine has already been approved in the UK. One prominent model estimates that despite early delays, daily vaccinations now exceed daily infections, and total vaccinations will surpass total infections in April.

From an investment standpoint, our list of quality growth companies is expanding as we continue to focus on research in this dynamic economy. Our perennial challenge is determining what price to pay for quality growth in a strong market. We will continue to exercise patience and discipline in the implementation of our investment strategy.