Economic & Market Commentary

Winter 2021

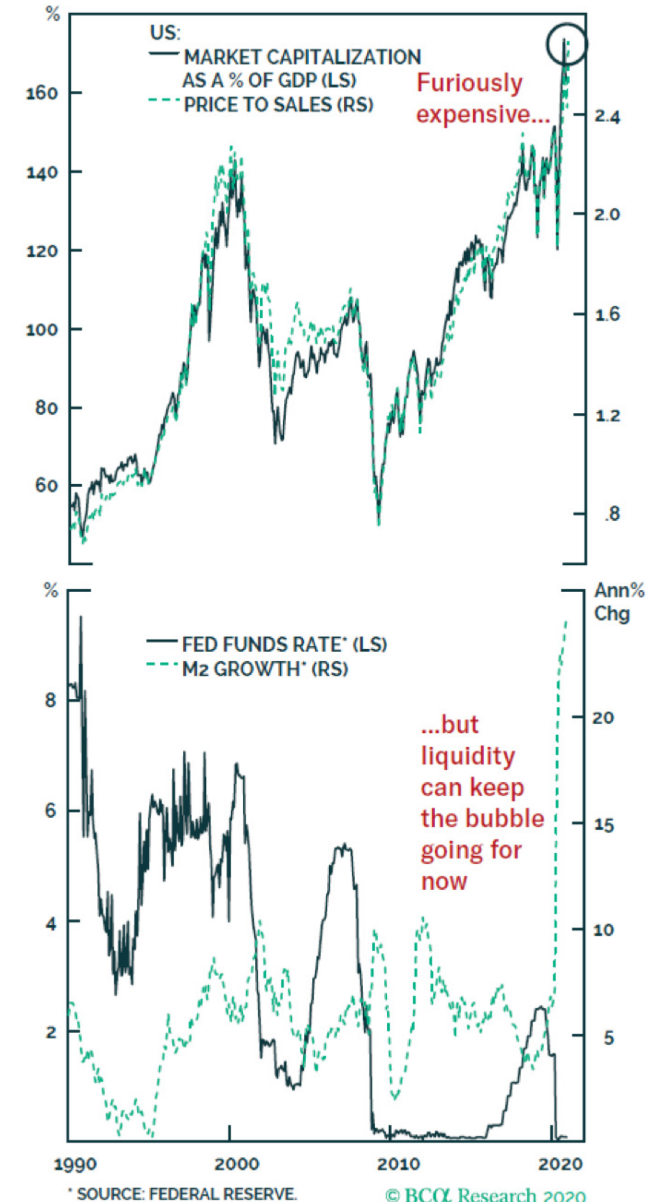
The First Chapter of a Better Book?

The new year is always a time of renewal, an opportunity to turn the page and start a new chapter. The year 2020 ended on a much better note than it began. Vaccine distribution appeared closer than previously thought possible. Massive fiscal and monetary stimulus brought economic activity – for most sectors – back from the abyss. Wide swaths – particularly service, travel, and leisure – remain under intense pressure. Overall, however, we enter 2021 with a higher degree of optimism than felt in some time.

Of course, much of this improvement is already reflected in asset prices. The S&P 500 rose nearly 70% from the March lows through mid-December, with participation broadening late in the year. The advance was so strong, and so fast, that market ratios of price-to-sales and price-to-GDP rocketed past 2019 peaks and now exceed those at the turn of the century top of the technology bubble. The accompanying chart on top, courtesy of BCA Research, shows this history. Can this continue? Yes, but… Those of a certain age remember the last episode of a similar buying frenzy did not end well. It is often said that the most foolhardy words in investing are, 'This time it's different'. Even with this warning firmly in mind, conditions exist that suggest financial assets may continue to rise into 2021 – with a caveat.

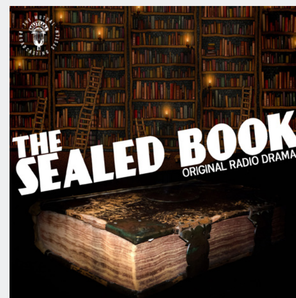
A mantra of these commentaries is that changes in monetary policies always affect financial assets before their impact is felt in the real world. We witnessed that in 2020; stock and bond prices rose as stimulus flooded the economy with cash – months before its economic benefits appeared. Expansive monetary and fiscal policies will continue well into the future. The Federal Reserve is committed to a zero-interest rate policy (ZIRP), and the new administration pledged a variety of stimulus programs to offset lockdown-related weakness.

While the latter is subject to negotiation between Congress and the administration, Fed actions are independent of politics (at least on the surface). The second chart on the bottom, also courtesy of BCA Research, shows the impact of recent Fed decisions on short term interest rates and broad money supply (M2, essentially checking, savings, and short term deposits). There is more of this to come. It will find its way to financial assets, at least in the near term.



Story Time

A staple of SiriusXM Radio Classics is 'The Sealed Book', a short-lived anthology series from 1945. The show opens with a low gong and a creaking door. The narrator tells us the keeper of the book has opened a 'ponderous door to the vault where the great book rests. It holds all the secrets and mysteries of mankind through the ages, of dark deeds strange and beyond belief.' While there were no episodes about 2020, it would fit well in the series – perhaps with a 'to be continued' signoff. Our view is that the creaking door stays closed in 2021.

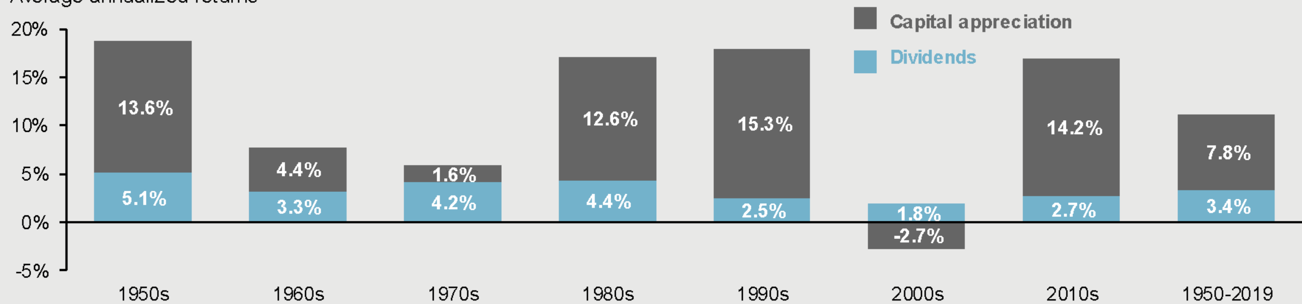


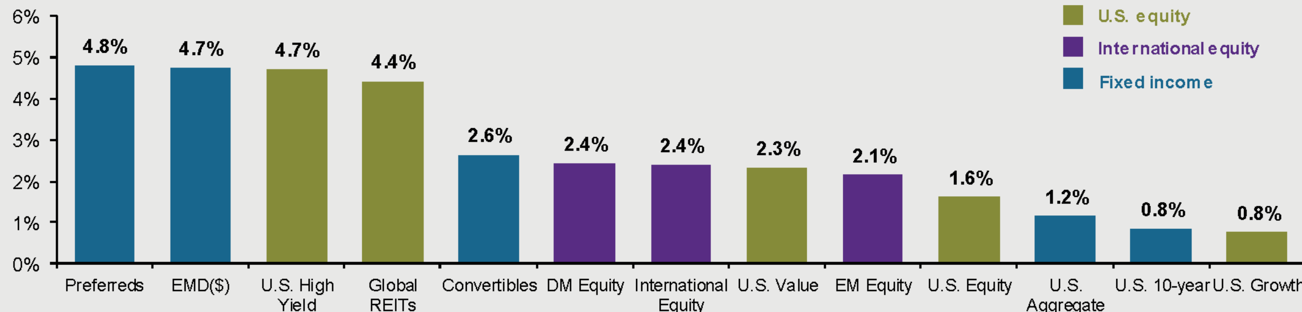
The Next Chapter

Last quarter's commentary discussed the impact of valuation on prospective returns. Valuation characteristics at the beginning of a measurement period are very reliable indicators of long term performance. And, we noted that equities were overvalued by every standard measure except those related to interest rates. This valuation challenge intensified late in 2020 as stock prices and speculative activity rose hand-in-hand. If history holds true, returns from traditional stock portfolios will be modest, at best, over the next few years – even with the help of the Federal Reserve. Anything can happen in the short term, but long term projections run pretty true to course.

The Plot Twist

The total return of an investment portfolio has two components – the change in the value of the assets owned, and the dividend and interest income compounded over time. The first is highly variable, but the latter is relatively constant. This foundational income stream accounts for almost one-third of the S&P 500 total return since 1950. It is a constant in a continually changing environment. See the top chart below from the J.P Morgan's November 30 Guide to the Markets.





Source: J.P. Morgan Guide to the Markets, November 30, 2020.

The income benefit of traditional assets will be diminished going forward. ZIRP will be with us for years. While, as noted, income dampens volatility, it will not be noticeably additive to total returns in future years unless investors broaden their horizons. The average income contribution to the S&P 500 total return was 3.4% per year over the last seventy years. Today, as shown in the bottom chart, the only major asset classes offering that income stream are the more 'tip of the tiger's tail' categories -- real estate, lower-rated and emerging-market debt, and preferred stocks.

Investor focus is price-centered. Historically, the income component of total return is relegated to secondary status. Going forward, if appreciation opportunities are muted (as we expect), attention to income will become more important. Yesterday's returns will not be duplicated with yesterday's portfolios.

Concluding Thoughts

The investment environment has changed. Investor behavior will follow. Equity representation should be more conservative – tilted toward value here and abroad. Fixed income holdings will be more risk-oriented to capture reasonable income streams. Portfolios under our guidance will reflect these expectations. Talk to us; we can help write a new chapter in your financial future.

Economic & Market Commentary is written by the Investment Services Department at Security National Wealth Management.