Financial Markets Perspective

April 2021

Avoiding an Apocalypse

In February of 2020, a little more than one year ago, the economy was humming along with moderate economic growth, record low unemployment, a robust corporate sector that was experiencing rising sales and earnings, and record high business and consumer confidence. And then the threat of an apocalypse arrived in the form of COVID-19 that blanketed the world and ushered in the first serious pandemic in over 100 years. The stock market collapsed by 36%, as measured by the Dow Jones Industrial Average, which fell from 29,551 to 18,917! Even worse was the almost 50% decline in the S&P 500 between mid-February and mid-March last year.

In mid-March, President Trump declared the novel coronavirus a national emergency and by the end of the month, he signed into law the CARES Act. The act was the largest economic recovery package in history, provided direct payments to Americans and expanded unemployment benefits. Despite this massive federal spending, many small businesses were forced to shut down and unemployment continued to rise. The Federal Reserve stepped in and drove interest rates to zero to assure support for the financial side of the economy. In addition, the Fed bought billions of dollars of securities, both government and corporate bonds, to ensure sufficient liquidity during the crisis. Such a commitment by both the federal government and the Federal Reserve had never been implemented except for during World War II. Stretching the analogy, the commitment to discover and then produce a vaccine to cure the disease was not unlike the U.S. promise to build a military force that would produce victory in that war.

In our first quarter 2020 FMP we said the following:

"In April of 1942, some four months after the U.S. entered World War II, the stock market bottomed and rose by well over 100% over the next four years -- even though the outcome of the war wasn't decided until 1944. Maybe the recent rally in the stock market is a forecast of better times ahead. The parallel is that equity markets anticipate solutions to problems well ahead of the resolution."

In hindsight, that analogy was fairly accurate. By Thanksgiving 2020, the stock market had fully recovered and gone to new highs. Fast forward to today and we are seeing a 37-year record high in manufacturing activity driven by strong growth in orders, production, and employment, along with increases in prices paid for inputs. The services sector also seems to be catching up due to pent-up demand, stimulus checks and increased optimism as vaccines are distributed. The ongoing relaxation of mask mandates and a significant increase in the U.S. populations' natural immunity will likely lead to an improving economy over the course of this year.

The Return of a Basic Economy

The broad stock market rally belies what has happened to sectors within the stock market during the pandemic. Up until early November, stock market returns were lopsided with the tech-heavy NASDAQ Composite index substantially outperforming other market indices. Companies that benefited from the pandemic and the shutdown flourished, especially those that either reinvented themselves or introduced new services that quickly became a support for stay-at-homers. Internet

companies that grew their businesses by appealing to online shoppers by adding such attractions as virtual vacations, home grocery delivery and prepared meals from local restaurants helped save many companies. Pharmaceutical firms that became engaged in searching for or supporting the research efforts that would lead to the discovery of a viable vaccine saw their stock prices surge. Conversely, businesses that depend upon group attendance or travel suffered dramatically and would have failed if it were not for various forms of government support programs. Airlines, cruise lines, amusement parks, movie theatres, concert halls, playhouses and restaurants all bore the brunt of the impact of the shutdown. The educational system also took a beating as children and teenagers could not go to school. Teachers were forced to learn how to conduct classes virtually. Similarly, businesses created a massive work-from-home capability to keep their companies and employees working. As a result, there were winners and losers here too. The elimination of group business meetings and conventions penalized companies offering these services while telecommunications companies, such as the virtual office via Zoom (a videotelephony company and online chat services through a cloud-based peer-to-peer software platform used for teleconferencing, telecommuting, distance education, and social relations), zoomed in value due to investor interest.

The rapid deployment of not one but three vaccines has started to turn the tide against the virus. Millions of Americans have been vaccinated and state governments have decided to open, resulting in increasing employment and economic activity. Traditional measures of economic growth have reappeared, and forecasts of 6-8% real growth have emerged; a rate that has not been seen for decades. As the first quarter of 2021 ended, proof that the balance was returning to the stock market emerged, as the widely followed indices such as the Dow Jones Industrial Average and the S&P 500 rallied to record highs.

Jamie Dimon, the CEO of JPMorgan Chase bank, recently forecasted a “boom” economy at least through 2023. The International Monetary fund (IMF) increased its forecast for global growth to 6% this year up from a previous forecast of 5.5% and Goldman Sachs predicts a growth rate of 8% for this year. Moreover, according to the Wall Street Journal, economists expect employers to add more than 7 million jobs for this year that equates to a gain of 5%. As we look around we see more evidence of a strengthening economy bolstered by a highly accommodative Fed, trillions of dollars of cash on the sidelines, and vaccines given to over 50% of Americans.

What could upset these favorable forecasts and negatively impact financial markets? As asset prices soar and the cost of borrowing to buy assets remain low, greed may expose one or more segments of the market to a meltdown. Over the past couple of months, three events exposed markets to the tip of that leverage iceberg. The speculative trading in GameStop and other stocks that were expected to go bankrupt led to a surge in prices as speculators were forced to cover their short positions and incur losses in the billions of dollars. The failure of Greensill Capital, a financial firm that specialized in supply chain financing, is one of the most spectacular collapses of a global finance firm in over a decade. It has entangled SoftBank and Credit Suisse and threatens the business empire of the British steel tycoon Sanjeev Gupta, who employs 35,000 workers throughout the world. The more recent collapse of the family office—Archegos Capital Management, from a handful of large bets on a few major stocks, highlights the need for transparency. Since the wagers had been made in part with total-return swaps—investments made by banks on behalf of clients for a fee—they obscured the company’s large exposure to several companies and cost Credit Suisse and Nomura billions of dollars. Not to mention the fact

that Mr. Hwang lost $20 billion in 2 days! These events and the related selling of equities added volatility to the stock market during the first quarter. However, once these events passed, the equity markets renewed the uptrend that began a year ago.

As we have mentioned on several occasions, the low interest rate scenario imposed on us by the Federal Reserve has a dark side—investors who rely on fixed income securities to provide them with a viable standard of living have suffered as safe securities such as money market funds or bank CDs have found their income shrink to almost nothing after inflation. Inflation fears perked up in the first quarter and long-term government bonds fell in price. The only reasonable return in the fixed income markets continues to be high yield securities where economic optimism has pushed the prices of these bonds higher. In a strong economy and the potential for further declines in unemployment and gradually rising inflation, interest rates will climb, and current bond investments will temporarily lose value.

Conclusions

The outlook for the economy and equity markets has never been better. The potential for a moderate tax increase is high, but given the growth rate outlook for the economy, such a tax increase would only slow growth, not reverse it. Unfortunately, there are several states that are planning major tax rate increases that may penalize businesses and high net worth individuals. We may see pockets of shortages develop as demand surges for the balance of the year – particularly in the semiconductor space. Investors should be less concerned about inflation arising from a shortage of goods due to a surge in demand than a surge in demand due to a collapse in supply. One example of the latter was the oil embargo in the early ‘70s when OPEC withheld oil from the U.S. and the lack of supply caused oil and gas prices to spike higher, a condition that does not exist today.

The impact of the pandemic will have long-lasting effects across the economy as many businesses have failed to adapt to a rapidly changing environment. Innovations to improve our standard of living may be retained and the “virtual” experiences will continue to occupy some of our leisure time. We may also see the continued use of masks and safe distancing even though the pandemic is over. One benefit to consumers practicing masking and social distancing is a dramatic fall in the occurrence of other illnesses such as the annual flu which all but disappeared over the past year.

Lastly, the private sector of the U.S. economy currently has a net worth of over $130 trillion and that is up about $12 trillion over the past year for a growth rate of 10%. Compare that to the liability side of the equation, represented by household liabilities, which only increased at a 1.3% annual rate since 2007. Moreover, private sector leverage is at its lowest level since 1976 and has declined 40% since the peak in 2009. Non-financial businesses are in even better shape as evidenced by the surge in corporate profits that grew to a record $431 billion or at a 27% annualized rate in the third quarter of last year. Corporate profits are forecast to rise at least 25% for the first quarter of this year on the back of pent-up demand. So, there is light at the end of the tunnel, and we expect the stock market to finish solidly in the green by the end of the year.

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