VICTORIA
Capital Management, Inc.

Financial Markets Perspective
July 2021

Mid-Year Review 2021

Staying the Course

Over a year ago, we expressed optimism about the domestic economic outlook because of the progress being made on COVID-19. Prior to the pandemic, the economy was on a solid growth track (after a decade of sub-par growth) primarily due to reduced regulation and lower tax rates. This rosy trajectory was cut short by the unexpected "plague" exported by China. When looking back (which is always an indulgence), we can say that both the federal government and state governments made a mistake by reacting too hastily by shutting down the economy. At the time, however, nobody knew that these effects of the shutdown would be so long-lasting and detrimental to many industries. Thankfully, the federal government re-reacted quickly and introduced a massive spending program and the Federal Reserve kept interest rates low to provide liquidity to the financial markets. These actions provided consumers and businesses with the tools to survive and turned around both the stock and bond markets that have been rallying to record highs without so much as a glance in the rear-view mirror. Investors regained confidence that a vaccine would soon be at hand and, as the economy moved into November of 2020, that solution was provided by not one but two companies! Initially, the prognosis was that a vaccine would be years away, yet American ingenuity coupled with a commitment by the government solved the problem in months and, by the beginning of 2021, vaccinations were underway that would protect millions of Americans. Unfortunately, in many countries the response to the pandemic was not as quick or efficient as in the U.S. and several relapses have continued to strike even more than a year after the initial spread.

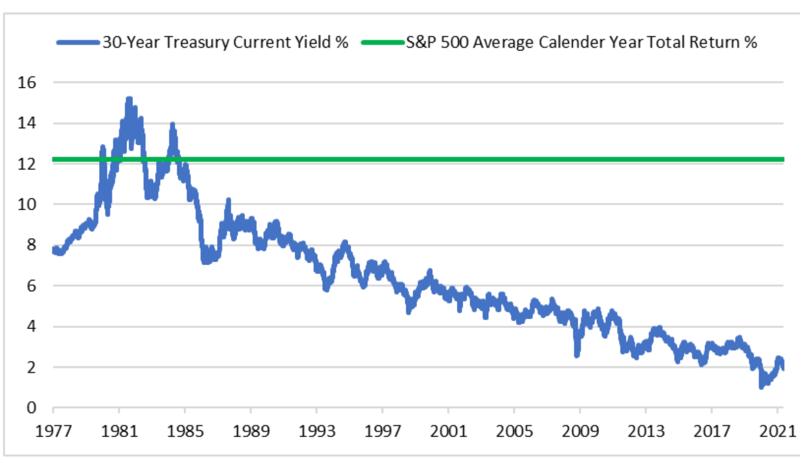
Our expectations for a solution to the crisis were underestimated – by a long shot – as we failed to factor in the spirit of America. American ingenuity was there at every turn to help us deal with the crisis. The U.S. response to the Japanese attack on Pearl Harbor and our ability to demolish the German Wehrmacht are two similar examples of how America responds to such "enemies." Entrepreneurs provided all kinds of services to people in lockdown mode. Companies such as Uber, a modern-day taxi service, became a company that delivered meals to people who otherwise could not leave their homes. Other companies such as DoorDash provided groceries to people who could not or would not go shopping for fear of getting the virus. Restaurants built outdoor facilities to survive and to meet with government-mandated rules. At almost every turn, Americans rose to the occasion and came up with solutions to the difficulties fostered by the virus.

The government's response was equally surprising. The Federal Reserve appeared to endorse some of the principles behind the economics of Modern Monetary Theory by demonstrating a willingness to "write the check," no matter how big, to provide an enduring safety net under the economy. In other words, the Fed stepped in and bought billions of dollars of government and mortgage bonds and dropped interest rates to record lows as evidenced by the fed funds rate (the rate that banks borrow from each other) of ZERO! Even today, the Fed is maintaining this policy even though the recovery is underway which has many economists and investors unsettled. This program was followed by all the foreign central banks and has provided emergency liquidity to the global financial system.

The federal government's decision to increase levels of spending and taxing also stimulated an economy suffering from the shutdown. Huge budget deficits were the result of massive distributions of cash to individuals and corporations affected by the shutdown. Plans to further increase spending by trillions of dollars are on the table this year as the Biden Administration is solidly behind ongoing fiscal stimulus. If the government resists a major increase in corporate and individual tax rates, the economy should continue to accelerate for the foreseeable future.

The Great Separation

Economists and financial market observers have had a history of referring to the bond market's performance over the past 30+ years as "the great bull market in bonds." The professors at Wharton, University of Pennsylvania said: "While many people think of bonds as conservative holdings, they have produced stellar returns for decades, thanks to the taming of inflation and other factors. A basket of stocks would have returned a mere 19% from the start of 2000 through 2011, for example, while a basket of bonds would have returned about 113% through a combination of rising prices and interest earnings." Most investors have agreed with this characterization as they saw the short-term value of their bond portfolio rise thus making the temporary capital appreciation on the bonds the largest contributor to returns. Imagine some forty years ago, the federal government was issuing 30-year bonds with a yield of 15%! No wonder the P/E on the stock market was around 9x. The current yield on newly minted 30-year government bonds is 1.9%! Obviously, the returns on bonds for the foreseeable future will not even keep pace with inflation thereby sending many investors into the stock market.
This 40-year drop in interest rates appears as a bull market for long-term bond investors but, in reality, lower interest rates gave the illusion of a high return. As interest rates declined and bonds matured, a long-term investor had to reinvest the proceeds at an ever-decreasing interest rate. For new bond investors, the choice was to take a declining bond return in comparison to yields of the prior few years or to shift more assets into stocks where the return was expected to be some combination of capital appreciation and dividend income. As the coupon on bonds fell, the return relative to stocks fell and those bonds became less competitive. As a result, the stock market P/E continued to rise and investing in equities surpassed investing in bonds with record low yields thus creating the Great Separation that can be seen in the chart below.



For portfolio managers who are given the charge of managing a “balanced” portfolio, the traditional approach was to put 60% in stocks, 30% in bonds and 10% in cash. When bonds were yielding double-digits and cash was earning 5%, this mix provided both the expectation of a long-term return of 10% for stocks and an income cushion from the bond portion of the portfolio when stocks fell. In today’s world, that traditional mix no longer offers a solution to meeting investor needs. With a government bond yield of less than 2% and a 0% return on money market instruments, how is an investor going to meet a return expectation of 5-10%? The only solution is to increase the allocation to equities and to maintain some reasonable cash cushion during difficult market times.

The history of the stock market demonstrates that if investors have a long-term time horizon, they will benefit from investing in stocks. Corporate earnings are the mother’s milk of stock prices, but dividends are the cream of investing in stocks over time. Virtually all other “investments” require that you sell that investment at a higher price than your purchase price. In the case of a diversified stock portfolio, dividends will reward that investment over time.
The problem with bonds is that the current interest rate is near record lows, and the buyer of bonds today will get stuck with that coupon until that bond matures. If bond prices go up, the investor cannot capitalize on that increase because they would have to sell their current bond at a loss to compete with higher yielding bonds. Bond fund investors must be careful about the “tools” used by portfolio managers to hype the yield of their portfolios. Jason Zweig’s article in last weekend’s Wall Street Journal is the perfect example of inflating yields to the unsuspecting public. He highlights the fact that Treasury inflation-protected securities (TIPS) mutual funds and exchange-traded funds (ETFs) are touting yields in excess of 8%! TIPS are bonds and notes issued by the Treasury that typically change in price with the consumer price index (one measure of inflation). So, when inflation rises, the market value and interest payout of TIPS will rise and when inflation declines, the market value and interest payout will fall resulting in a lower yield. In marketing materials and online, the mutual fund and ETF companies will advertise what is called the 30-day SEC yield which has skyrocketed of late due to the massive month over month increase in inflation as measured by the CPI. In his examples, only State Street Global Advisors and Vanguard are reporting the 30-day SEC yield without the inflated inflation component. If something sounds too good to be true it usually is not. After all, seeing an 8% yield in a 2% interest rate environment is questionable -- to say the least.
Given the Great Separation that has taken decades to create, the option to purchase stocks versus bonds is not a difficult choice for long-term investors.

Conclusions

The COVID crisis appears to be largely over except where vaccinations are scarce and variants have surfaced. Many industries are still struggling to fully recover and getting back to “normal,” whatever that was, will probably never happen. The American spirit is alive and well and we expect those companies that re-fashioned their business models (remember our Survival of the Fittest theme?) will come out on top. Variants of the virus have become a short-term problem for pockets of the global economy, but drug companies are still pioneering vaccines and antibodies to combat this enemy. Getting the rest of the world vaccinated will be crucial to put this catastrophe behind us so that we can move forward. Investors have shrugged off the bad news as most domestic equity indices have been hitting new highs. Many foreign stock indices are also up by double-digits at this mid-year review. Unfortunately for long-term bond investors, yields are hitting new lows making it virtually impossible to replace the higher yielding securities in a portfolio.

Summer is always a volatile time in the stock market. We expect short-term corrections on the back of fears of tax rate hikes for both corporations and individuals and increasing government regulation—both bad news for equity investing. Remember the tax rate increase that President Clinton imposed on the economy in 1992? After two years, voters kicked the dominant Democratic party out of power in the November 1994 elections. After Clinton was re-elected in 1996, he became a tax rate reducer and introduced the capital gains rollup for the sale of individual homes.

Add in the fact that equity markets may be reflecting "too much of a good thing." Low interest rates coupled with zero trading fees has triggered an unusual surge by short-term day traders who use margin (borrowed money) to buy and sell stocks. This speculative buildup could be unwound swiftly if the Fed decides the economy is recovering too fast. One need only look back to the market decline in the fourth quarter of 2018 where stocks fell by 13.5% as measured by the S&P 500 -- erasing gains in all prior three quarters and finishing out the year down 4.4%! We have learned in our combined 88 years of investing in stocks not to be complacent!!

On a brighter note, watching Richard Branson last week take the private sector to a new high by soaring to the edge of space with passengers aboard his ship Aurora reminds us of the value of the American spirit (even though he is a Brit). American Jeff Bezos launched his New Shepard Rocket (part of his Blue Origin company) today to the same edge of space confirming the importance of entrepreneurs and the private sector to economic growth. When was the last time the government sent up a space shuttle? The last flight was Space Shuttle Atlantis on July 8, 2011! Not many other countries foster such feats by the private sector and investing in companies that accomplish great undertakings will reward investors over the long term. The best is yet to come!!

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