MEDALLION WEALTH MANAGEMENT

December 2020 Market Commentary

Break On Through

You know the day destroys the night
Night divides the day
Tried to run
Tried to hide
Break on through to the other side

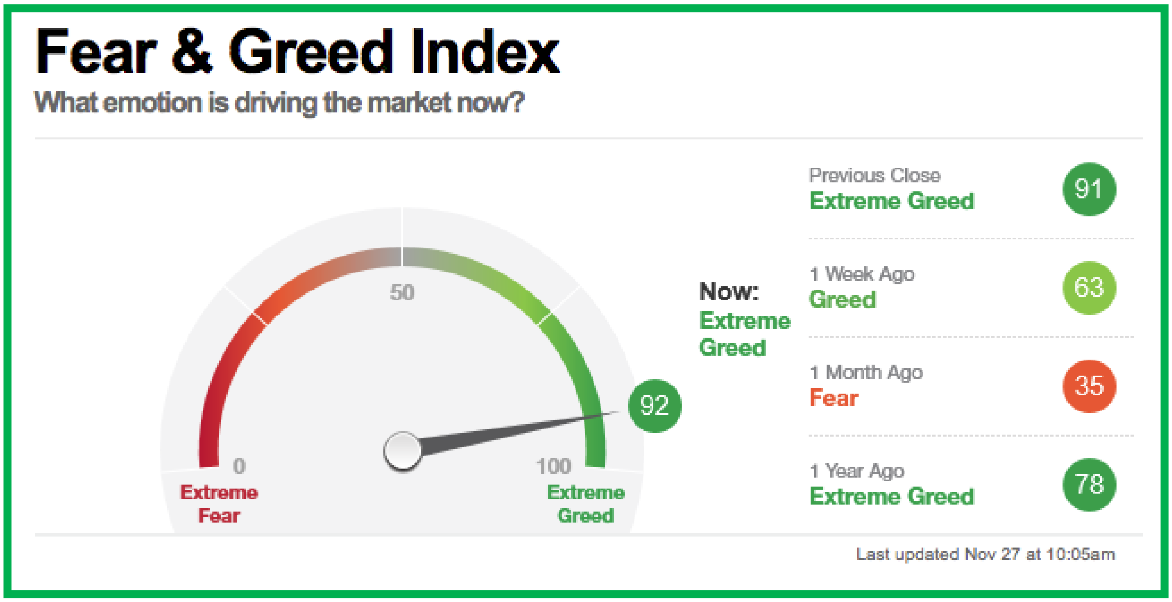
https://www.youtube.com/watch?v=CbiPDSxFgd8

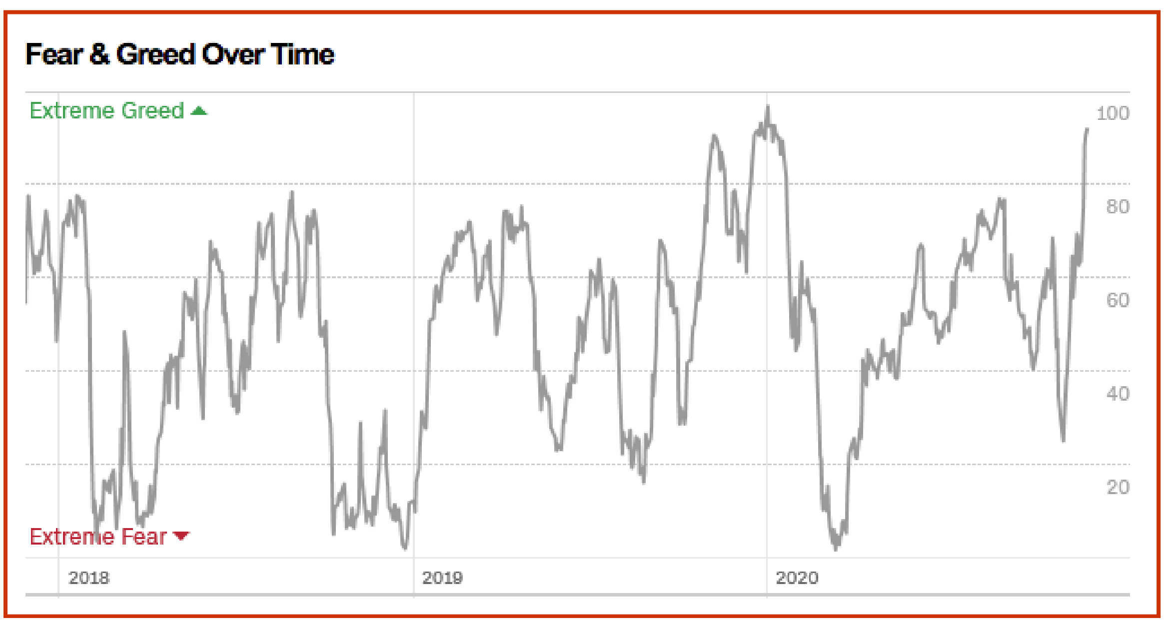
Covid-19 may have tried to destroy us, but the market and we are managing to "break on through to the other side." It has been amazing to watch: as businesses closed, as unemployment soared, as tens of thousands died, the market has been able to rally 70% from its initial collapse and march on to new highs. Certainly the immediate and unprecedented trillions in support from the Fed and Treasury aided us, but there was also a belief that we would have scientific breakthroughs on the vaccine front.

Initially the trillions in liquidity kept the country out of a depression, and those companies that could still prosper during the pandemic were rewarded. But more recently the announcements of effective vaccines on our doorstep have broadened the rally to those companies that were most severely impacted by the virus, namely travel and energy.

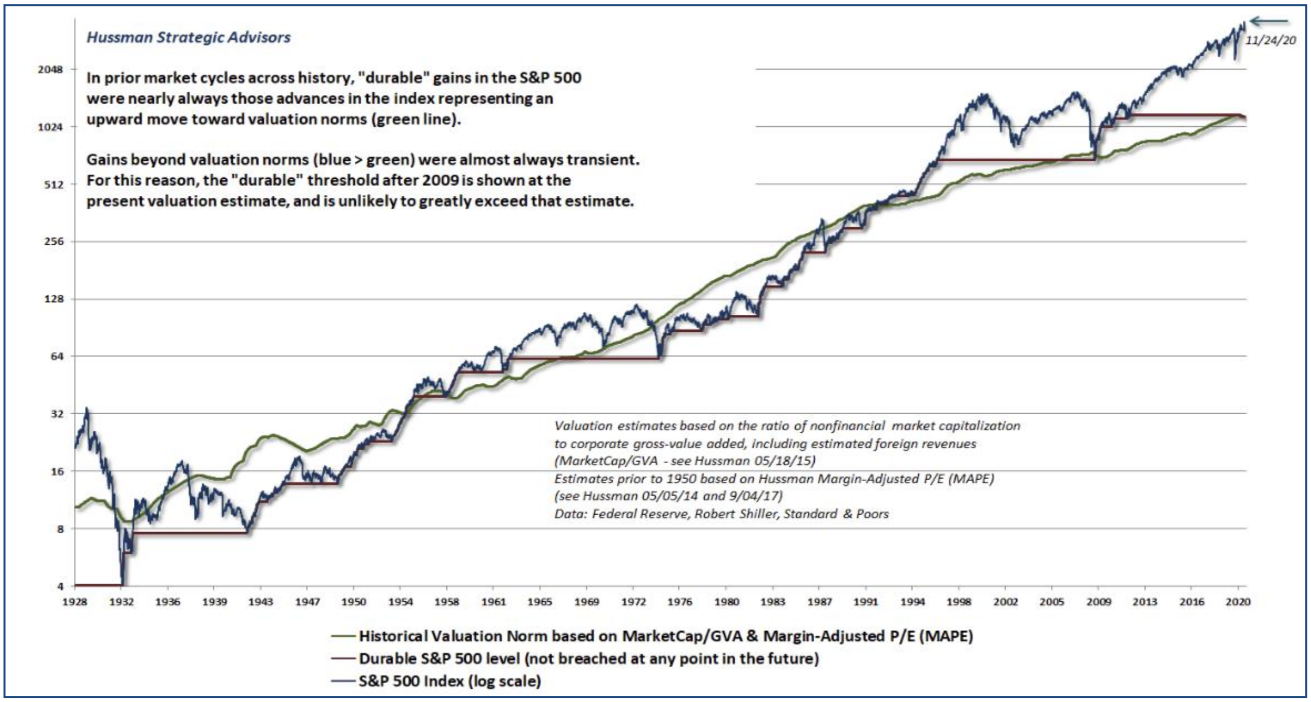
Even with infection rates hitting new highs, with lockdowns increasing, and football games being cancelled, the markets have looked through it all as the Dow Jones Industrial average finally broke through 30,000. Investors have simply stopped worrying about downside risks. Their willingness/eagerness to look towards a bright and shiny new future is really a testament to mankind's optimism.

CNN puts together a Fear & Greed Index that is currently flashing an Extreme Greed signal of 92. This index is made up of seven components that track various levels of investor sentiment. Generally its best to make new investments when fear is extreme, and it pays to be cautious when greed is extreme. Sometimes it's important to remember that the S&P 500 was up 32% in 2019, and is up another 15% in 2020, even though earnings are expected to be down about 17% this year and will hopefully be back to 2019 levels by the end of 2021.





Yes, the market has broken through to the other side, but how much good news is already priced in to today's valuations. Well, if you use outdated investment tools like skepticism and math, the answer is quite a lot. The chart below, from John Hussman who does some great historic valuation work, shows that stocks are currently trading significantly above their normal historical valuations. Valuations are horrible market timing tools as stocks can spend significant periods of time above or below their normal valuation levels. At best valuation measures give us a sense of our current risk environment and potential future returns. Higher current valuations equal more risk and lower potential future returns, while lower current valuations equal lower risk and higher potential future returns.



The above chart seems to indicate that our current level of overvaluation relative to historic norms rivals the overvaluations experienced in 1929 and 2009, but maybe this is justified. There is a vocal and growing school of thought out there that says today's level of valuations are justified because of our central banks zero interest rate policy, and also their willingness to step into financial markets actively buying bonds, mortgages, and even stocks in some countries.

This active intervention combined with zero rates means that stocks will have a lower equity risk premium and therefore a much higher PE/valuation than historic norms. When we witnessed the collapse in the economy and markets last March, and then the immediate response by the Fed and Treasury, how can we not be impressed? If Covid couldn't kill the bull, what will?

This theory of permanently higher valuations may be absolutely justified, but I personally struggle with the thought of stocks as the new risk-free asset.

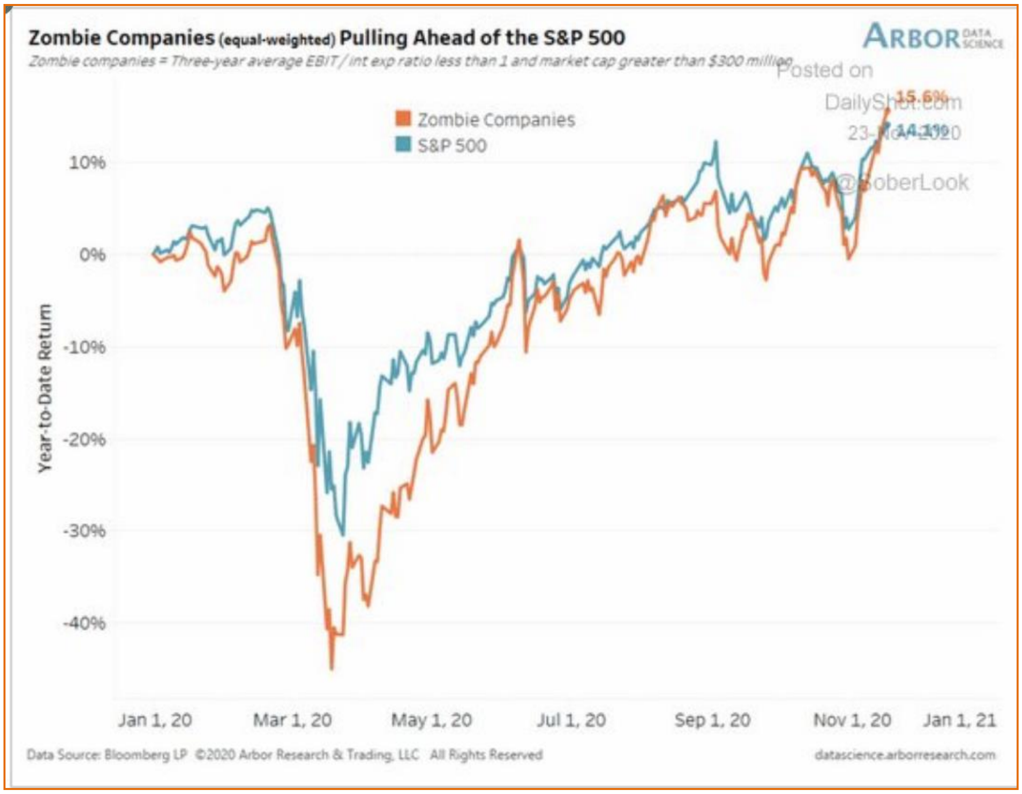
But what do I know; currently the "smart money" is all the new retail investors buying any stock that's going up. Don't believe me, just look at the chart below. The S&P 500 is up 15% YTD, the most widely owned hedge fund stocks are up about 35%, while the most widely owned stocks of retail investors are up a stunning 75%!

These new retail "investors" aren't your old Peter Lynch style investors who buy what they know and hold it. No, these new investors buy whatever is working today and sell it when it quits working. Knowing what you are buying is so yesteryear. How else can you explain the surge in SPAC's (Special Purpose Acquisition Company's), which are blank check shell companies designed to take companies public without going through the traditional IPO process (none of those pesky SEC disclosures).

I love that so many new investors used some of their free time and their Trump cash to invest in the stock market. I just hope they take some of their gains off the table before Mr. Market does it for them, or as the Doors said:

We chased our pleasures here
Dug our treasures there
But can you still recall
The time we cried
Break on through to the other side

I'll close with one last chart that I found interesting this month. It shows just how well zombies are doing in this environment. A zombie company is a company that cannot make enough money to service the interest on their debt and therefore can only survive through the issuance of new debt. Deutsche Bank estimates that this distinction actually applies to a record high 18% of U.S. companies. Well, so far this year the zombie companies have managed to outperform the S&P 500.



The risk-on momentum trade is certainly in full force as we approach yearend, and it wouldn't surprise me if it continues some, but…

But, old age and the scar tissue from more than a few bear markets tell me that we have already priced in a lot of great news, and Mr. Biden's honeymoon may be rather short lived. Time will tell.

As always, be careful out there.

Chris Wiles, CFA

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