MEDALLION
WEALTH MANAGEMENT

January 2021 Market Commentary

Shake It Off

'Cause the players gonna play, play, play, play, play
And the haters gonna hate, hate, hate, hate, hate
Baby, I'm just gonna shake, shake, shake, shake, shake
I shake it off, I shake it off

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

Ahh Yes, the Taylor Swift market. No matter what you throw at it, no matter how much you hate it, it just shakes it off and marches higher. In fact, I've shaken my head in disbelief so much this year my chiropractor has given me my own chair.

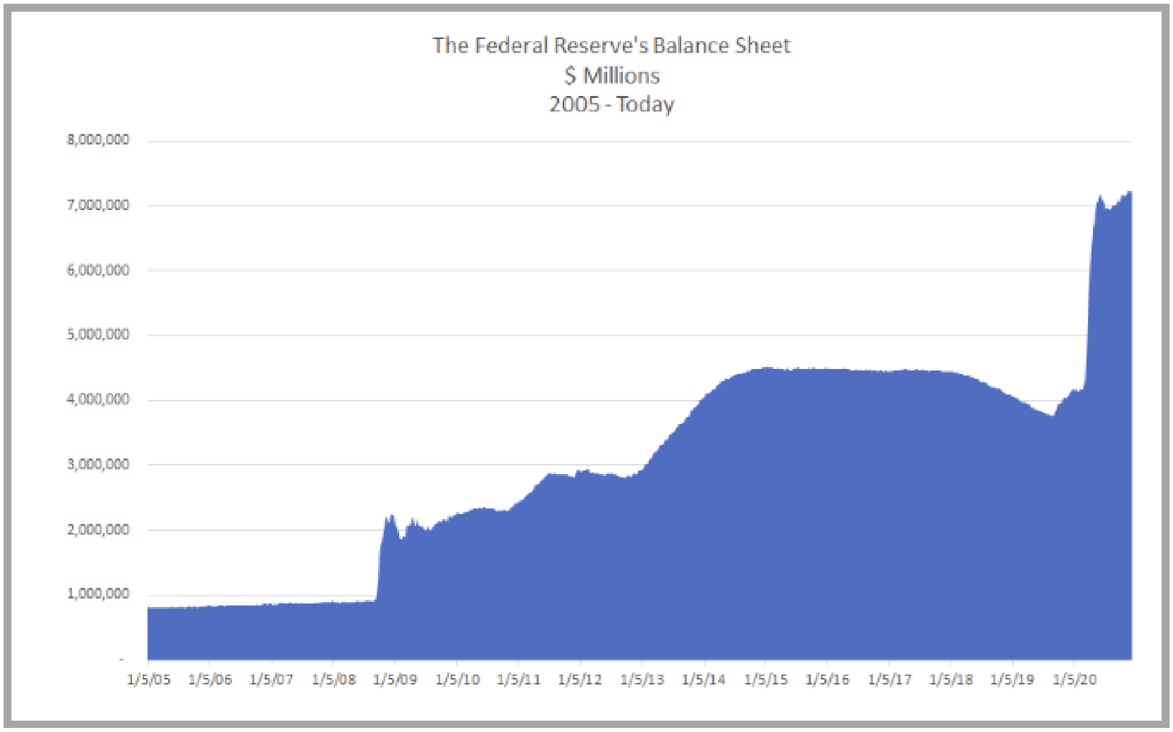
As 2020 began we were dealing with a pretty bullish scenario, we had record low unemployment, record high earnings, and a President who was sailing towards reelection, but then Covid-19 hit and the wheels fell off. The economy plunged into its deepest recession since the Great Depression, unemployment soared, and people were actually dying in unprecedented numbers.

As you would expect the stock market plunged, **dropping 35% in 30 days**, but then something totally unexpected happened, we had one of the strongest bull market rallies in history. The S&P 500 climbed to multiple new highs, **up a stunning 70% from its March lows.**

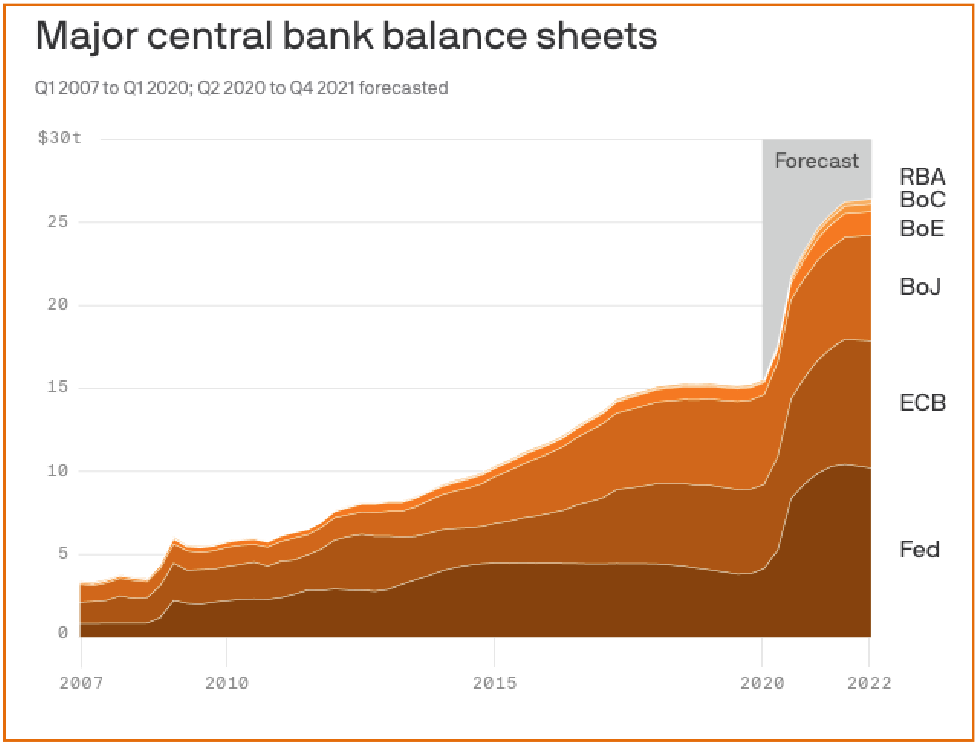
Imagine that you were trying to forecast the markets return in January of 2020 and you correctly forecast the epidemiological consequences of Covid-19, you then correctly recognized that the economy would plunge into the deepest recession in centuries. Also knowing that the market was already up 31% in 2019, already sitting at record highs and record high valuations, would you have been crazy enough to predict a further **18%** advance in 2020? Absolutely no one would have predicted this outcome, but that's exactly what happened.

Supposedly the most dangerous words in investing are, **"it's different this time."** But this year really was different, and **the biggest difference by far was the massive amount of fiscal and monetary stimulus pumped into the economy and markets**. Having learned from the 2008-09 financial recession the Fed and Treasury acted quickly and forcefully to mitigate the financial damage caused by the shutdowns.

After having a balance sheet that was consistently under $1 trillion, we thought they got a little crazy in 2009 with all of their Quantitative Easing causing assets to double to over $2 trillion and interest rates to plummet. What did we know, 2020 saw the Fed's assets skyrocket to over $7 trillion and counting. $3.7 trillion are in Treasuries, over $2 trillion are in mortgages (nearly 33% of the mortgage market), and they are even buying high-yield corporate bonds. Anything and everything is on the table.



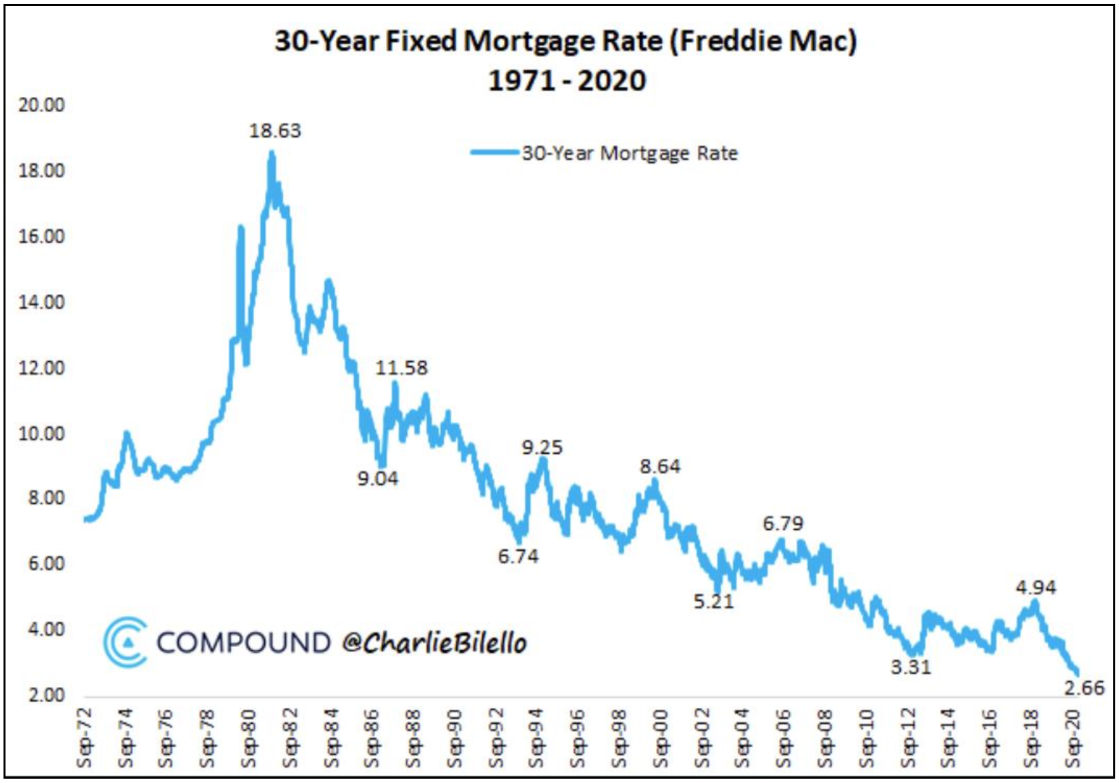
And we're not alone; every major central bank followed the same playbook buying assets at an astonishing pace. This asset buying has led to record low interest rates around the globe and **over $18 trillion in negative yielding debt**. In fact the United States has some of the highest yielding debt with our 10-year Treasuries yielding 0.94%, compared to Italy at 0.52%, the UK at 0.21%, Spain at 0.06%, Japan at 0.03%, and Germany at -0.57%.



Massive liquidity injections have allowed corporations to refinance existing debt and take on new debt at record low interest rates. Unlike normal recessions where you have a surge in bankruptcies, in 2020 we've had a surge in zombie companies. Zombie companies, those companies that don't earn enough to make interest payments, only exist when they can constantly rollover their debt. The number of zombies has grown from 4% in 1980 to over 16% today.

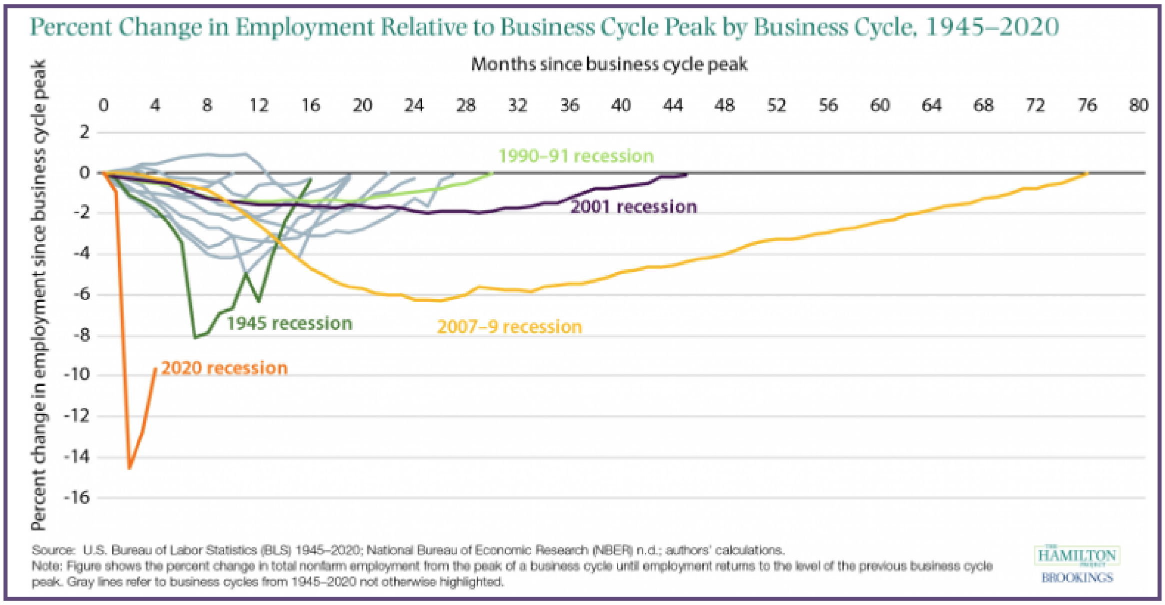
For many corporations the pandemic, and more specifically the Fed's response, has been a boon. Many corporations have been able to cut costs, both operationally and financially, and have actually seen their margins expand. New companies were also able to tap into the liquidity tsunami via the IPO market. **Companies raised a record $167.2 billion through 454 offerings, which shattered the 1999 dot-com record of $107.9 billion.**

Individuals haven't been left out of the excessive liquidity party. The biggest debt for most households is their mortgage, and with the Fed buying a third of all mortgages driving mortgage rates to record lows, we've seen record high refinancing and a 14-year high in existing home sales. According to the most recent Case-Shiller home price index, home prices are up an impressive 8.4% year-over-year.


30-Year Fixed Mortgage Rate (Freddie Mac) 1971 - 2020

Unfortunately not everyone has been able to skate through 2020 unscathed. While the Fed has been able to mitigate broad financial damage, we still have a very sizable part of the population who are suffering. We still have 10 million fewer people employed than in February.

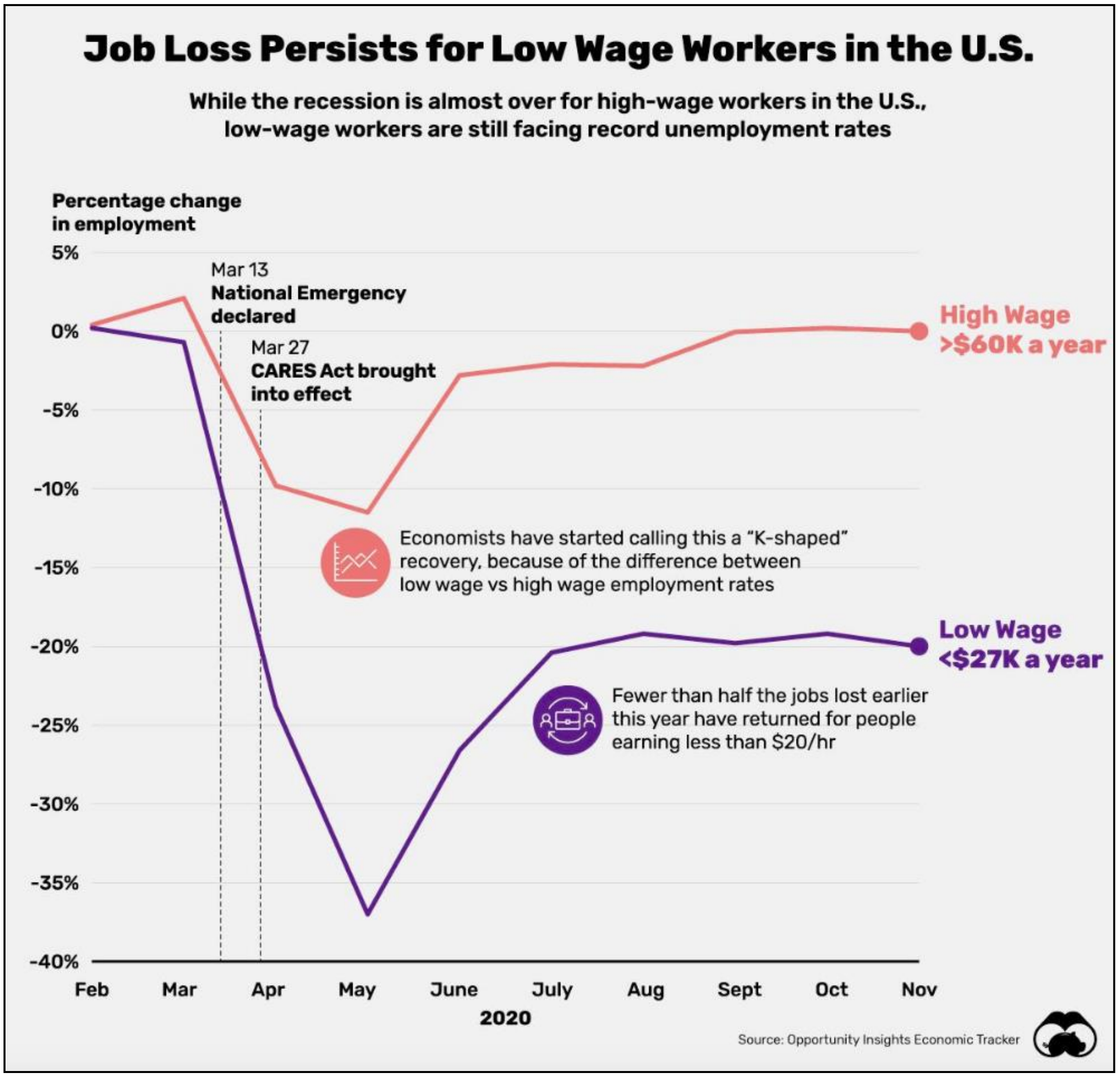
Unemployment shot to over 14% in March but has now declined to about 6.7%, which is still higher than the unemployment rate ever got in the 2008-09 recession.


Percent Change in Employment Relative to Business Cycle Peak by Business Cycle, 1945–2020

Source: U.S. Bureau of Labor Statistics (BLS) 1945–2020; National Bureau of Economic Research (NBER) n.d.; authors' calculations.
Note: Figure shows the percent change in total nonfarm employment from the peak of a business cycle until employment returns to the level of the previous business cycle peak. Gray lines refer to business cycles from 1945–2020 not otherwise highlighted.

In the early days of the recovery there was a lot of talk about what shape the recovery would take. Would it be a fast V-shaped recovery, a more drawn out U-shaped recovery, or maybe an L or Nike swoosh. In actuality it appears that we are experiencing a K-shaped recovery. In a K-shaped recovery you have different segments of the economy recovering at different rates and or magnitudes.

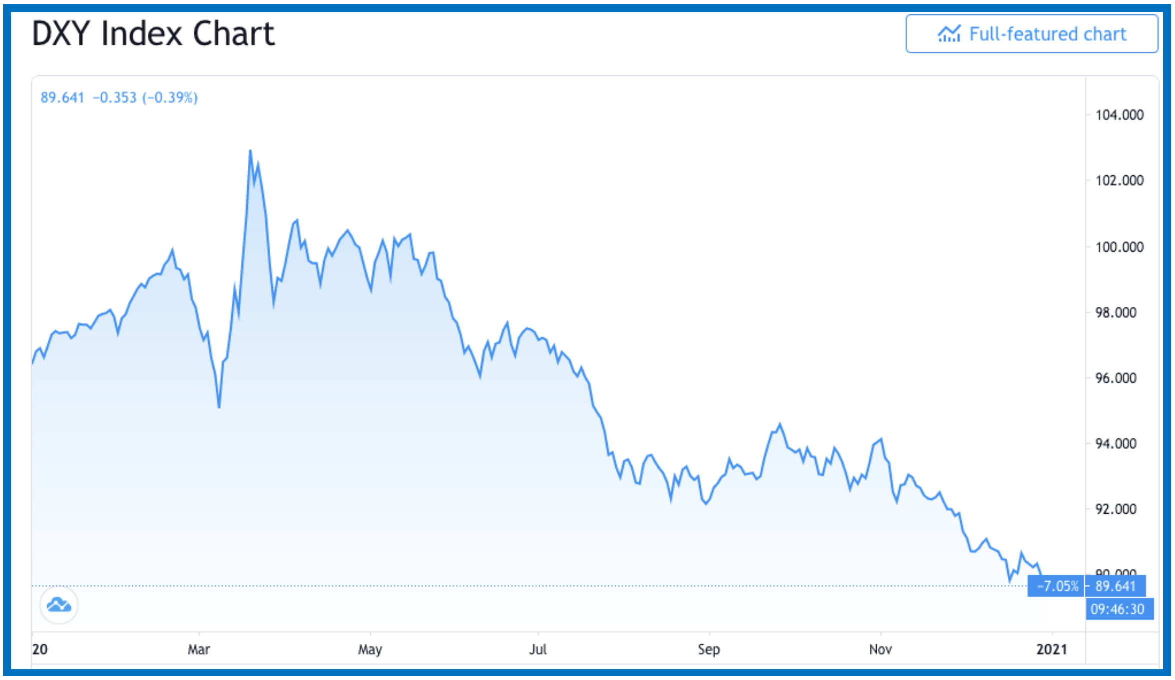
For those able to easily transition to working from home, 2020 was more about isolation than economic hardship. For the millions that couldn't make the transition 2020 has been devastating. While the overall unemployment rate is 6.7%, the graph below shows that higher wage earners have experienced little change in employment, while low wage workers are experiencing 20%+ unemployment.



Those higher earning individuals were not only able to keep their jobs, but they also probably saw their homes and 401-K's appreciate. The wealth gap accelerated in
2020 and will be an even bigger story in 2021 and beyond.

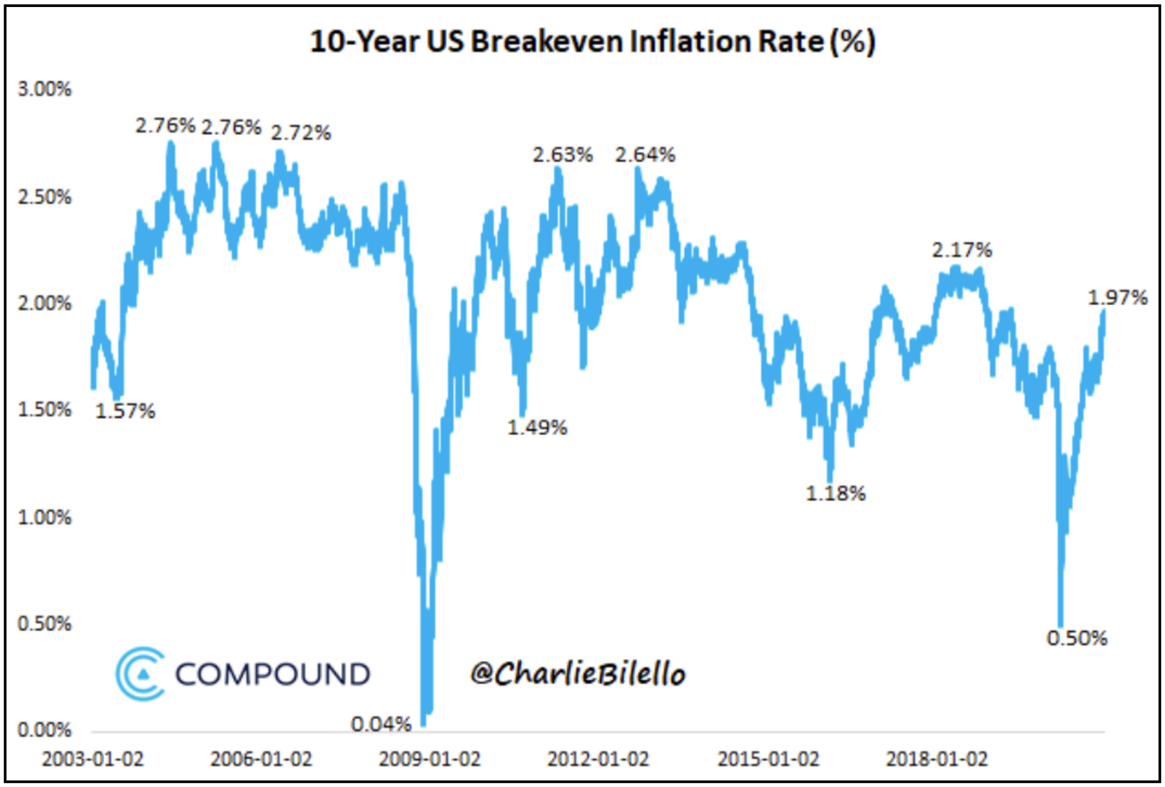
Of course all of this "Free Money" isn't really free, is it?

I don't think so. You would think that there would have to be a cost to all of this heavy-handed manipulation of the capital markets by the globes Central Banks. Right? Obviously we've seen massive inflation in financial markets with nearly all equity markets at record highs, corporate yield spreads and interest rates at record lows. We are also starting to see rather significant deterioration in the value of the dollar. The dollar has fallen about 11% from its March high.



What’s a bit surprising about the dollars accelerating fall is that it is counter to the conventional storyline. If the U.S. economy is going to be booming back in 2021, with widespread vaccinations and reopenings, then the dollar should be strengthening not weakening. Also, considering nearly all of Europe and Japan sovereign debt yields significantly less than U.S. Treasuries the dollar should be in demand overseas.

Therefore the dollars weakness, in spite of its relative attractiveness, is signaling that perhaps unlimited printing is not free. As the chart below shows 10-year inflation expectations have shot up from a low of 0.50% back in March to nearly 2% today. While 2% doesn’t sound like a lot, it may start to matter considering the amount of debt accumulated by both individuals and governments over the last several years.

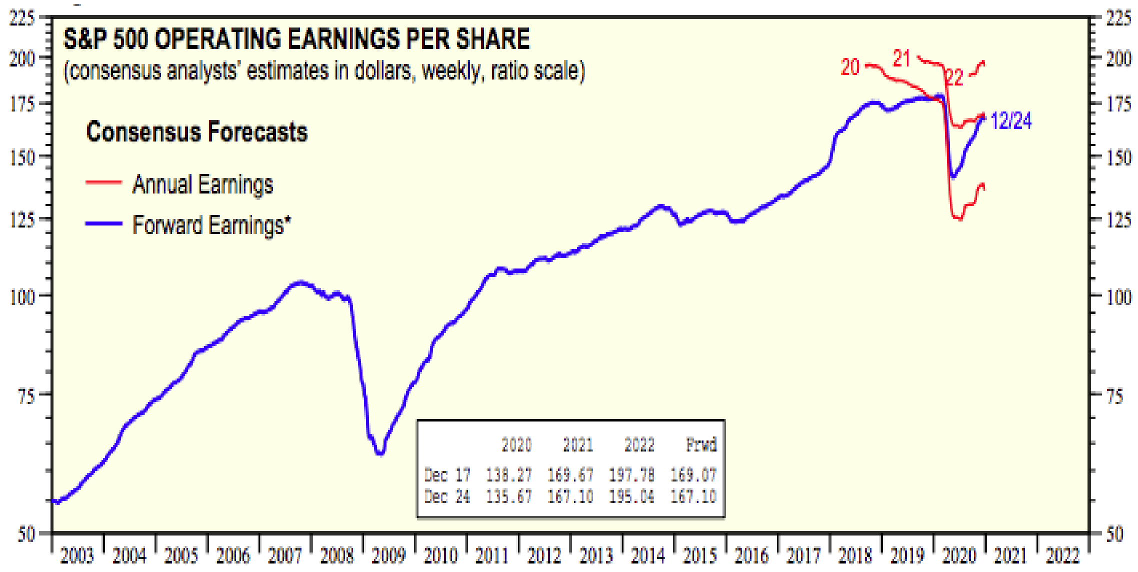


So, where does that leave us as we head into 2021?

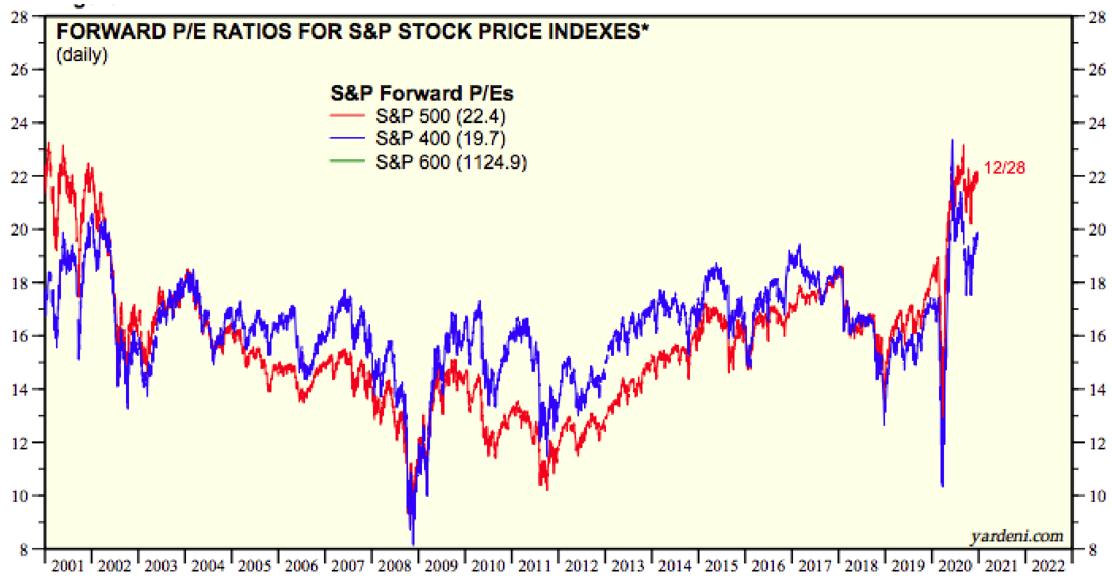
Remember that the total return for stocks is simply a function of three things:

1. **The Dividend Yield –** currently at 1.53% for the S&P 500.
2. **The Growth of Earnings** – in 2019 S&P 500 earnings hit a high of $163, in 2020 they are estimated to be about $136 (a drop of 16%), and in 2021 they are expected to fully recover to $167 (a gain of 23% over 2020 but only a gain of 2.5% over two years).
3. **The Change in PE -** or what investors are willing to pay for those future earnings and dividends. At the end of 2019 investors were willing to pay about 18x for future earnings. Now at the end of 2020 investors are paying a nearly record high of 22.4x future earnings.

The key to forecasting the future is trying to figure out if investors will be correct in assuming that earnings in 2021 will fully recover their pandemic losses, and whether or not investors will still be willing to pay a record high earnings multiple for those earnings. I personally take great pains in trying not to forecast the future, but I do try to at least understand what the market is pricing in, and currently it is pricing in a very rosy future with little room for disappointment.



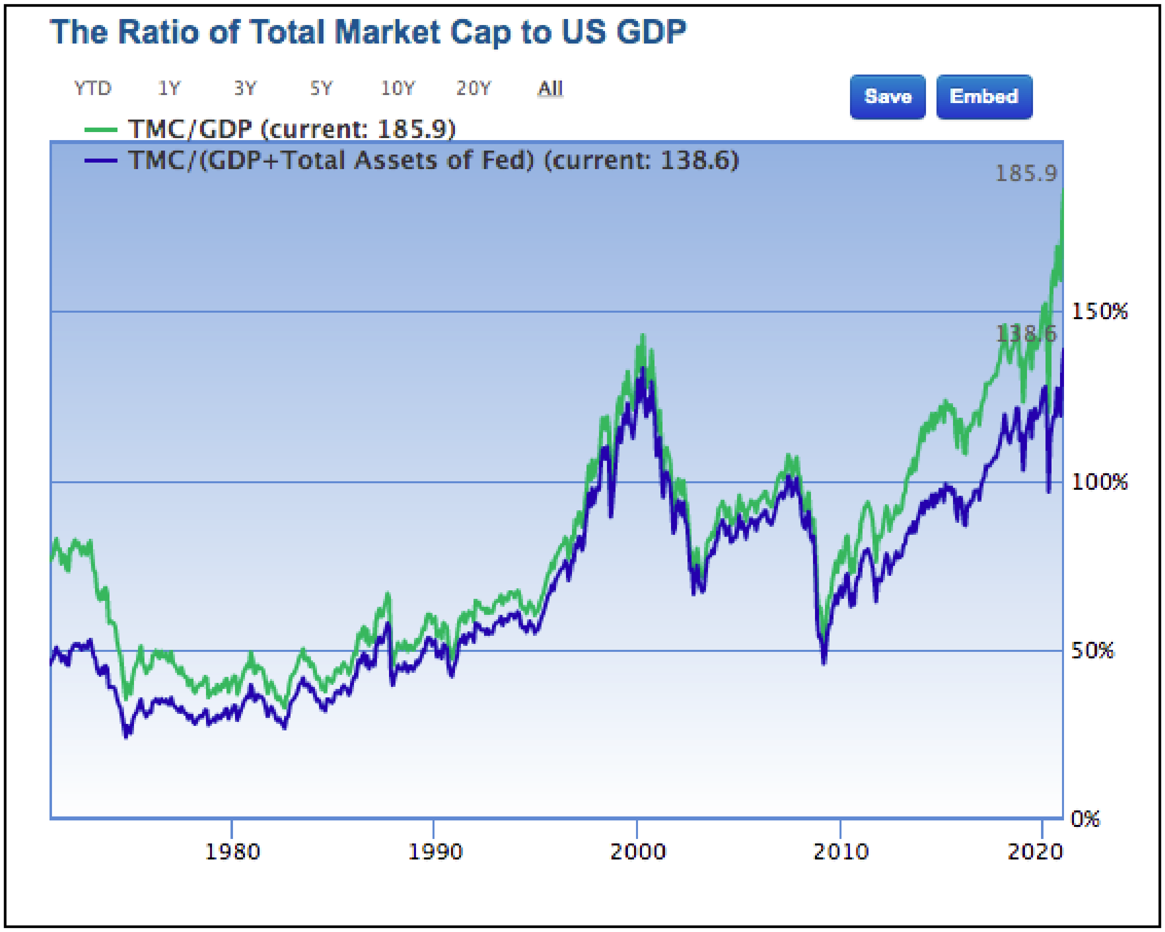
	2020	2021	2022	Frwd
Dec 17	138.27	169.67	197.78	169.07
Dec 24	135.67	167.10	195.04	167.10



* Daily stock price index divided by 52-week forward consensus expected operating earnings per share.
Source: Standard & Poor's and I/B/E/S data by Refinitiv.

Speaking of valuations, there are dozens of charts that I could show you that basically all show the same thing…namely that stocks are trading at record high valuations. For brevities sake I'll leave you with just one, the so-called Buffett Indicator. Warren Buffett has said that his favorite market valuation indicator is the ratio of the total market capitalization of all stocks divided by the total of U.S. GDP. The graphic below shows that according to this indicator stocks are trading at record high valuations, which generally translate into rather lackluster future returns.

The Buffet Indicator



As most of you are probably aware valuation indicators are good at helping manage risk on a longer term basis, but are notoriously poor at timing when a bull or bear may happen. Or as John Maynard Keynes so famously said, **“Markets can remain irrational longer than you can remain solvent.”**

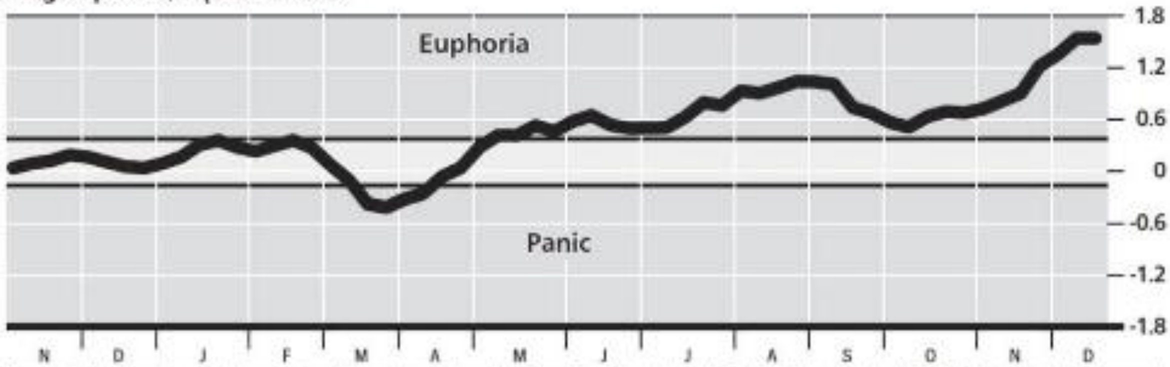
Other than valuation, another tool we can use to determine the riskiness of a market is **“Market Sentiment”**. Market sentiment tries to measure levels of fear and greed in the markets. This is where investing becomes more of an art than a science. Sentiment measures try and quantify opinions/feelings/emotions. It’s observable, but highly subjective. Or as Supreme Court Justice Potter Stewart famously said when referring to obscenity, **“I know it when I see it.”**

There are signs of excessive froth nearly everywhere you look. From IPO’s that double on their first day of trading, to the record issuance of SPAC’s (Special Purpose Acquisition Companies). A SPAC is simply a blank check shell corporation designed to take companies public when they find a good idea. This is equivalent to buying a company with no earnings, no sales, no business, just the idea that they might find you something good to invest in. Something that doesn’t need to go through those pesky SEC filings. Then there is the incredible run up in anything to do with clean energy, or electronic vehicles, or cyber security, or crypto currencies. It may be hard to define euphoria. But I know it when I see it.

One company that has tried to objectively define panic and euphoria is Citigroup. In 1987 they came out with their panic/euphoria model, which measures nine different market indicators, like put/call ratios, short interest, and margin debt. The indicator correctly identified the brief panic that set in back in March, and is currently indicating that **we are at a euphoric reading of 1.61**. How high is 1.6? Well until this December the highest reading ever was 1.48 in April 2000 right before the dot-com bubble burst.

Market Sentiment LAST +1.61

Citigroup Panic/Euphoria Model



The panic/euphoria model is a gauge of investor sentiment. It identifies "Panic" and "Euphoria" levels which are statistically driven buy and sell signals for the broader market. Historically, a reading below panic supports a better than 95% likelihood that stock prices will be higher one year later, while euphoria levels generate a better than 80% probability of stock prices being lower one year later.

Source: Citigroup Investment Research - US Equity Strategy

Now of course I have no idea whether or not the market will retreat in 2021, or simply continue to shake off my out dated worries. I do believe that future returns will be much more muted than those we've recently experienced, and that investors should probably diversify and maintain some dry powder just in case the rosiest of rosy scenarios doesn't pan out.

Here's wishing you all a very happy and healthy New Year. Be careful out there.

Chris Wiles, CFA

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