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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A Turn in the Calendar

Following the challenges faced in the year 2020, hopes were high that 2021 would bring better news. The first few weeks of the New Year were a reminder that January 1st was simply a turn in the calendar. In the U.S., COVID cases continued to surge as did hospitalizations in many parts of the country. Owing to additional COVID-related restrictions at the state level, economic activity ebbed slightly, and this translated into slower employment gains in December and January. The January 6th assault on the U.S. Capital during the certification of the presidential election and the subsequent impeachment vote by the House capped a tumultuous start to the New Year. The years 2020-21 are turning out to be historic; a period when our country has been tested like at no time in recent decades. While early January felt like a collective low point in our nation's history, the system functioned as envisioned by the Founders, and a new administration took office on January 20th.

The stock market continued its impressive rebound during the fourth quarter of 2020. For the quarter, the S&P 500 had a total return of 12.1% and for the full year the index returned 18.4%. The factors behind the market's strength have been consistent since the spring of 2020: gradually improving economic data, record levels of fiscal and monetary stimulus, historically low interest rates and tame inflation. There was a noteworthy change in the stock market leadership during the quarter. For the first time in many years, value stocks outperformed growth stocks and the S&P Value Index returned 14.5% vs. a 10.7% gain for the S&P growth index. Time will tell if this is the start of a longer-term trend.

It is still early in the New Year. The challenges of COVID remain significant, but the accelerating roll-out of vaccines should start to impact infection rates by early spring. In the U.S., over 30 million vaccine doses had been distributed by mid-January according to the CDC. The incoming administration has telegraphed its intention to provide additional economic stimulus in the coming months. Interest rates and inflation remain at levels that are supportive of economic growth. The valuation of the overall stock market is high by historical standards, with the S&P 500 trading at 23 times consensus earnings estimates for 2021. However, within the stock market there are a number of sectors with reasonable valuations and attractive dividend yields.

In summary, there are reasons to be encouraged about the remainder of 2021. As always, there will be challenges, and foremost among those challenges will be balancing the near-term need for additional fiscal and monetary stimulus to support an economic recovery while remaining mindful that there are very real limits to the borrowing power of a sovereign government.

The Responsibilities of Privilege

For much of the last century, and particularly since the end of World War II, the United States has occupied a leadership position in terms of economic, diplomatic, and military influence. This leadership position is a result of many factors: democratic values, an innovative and flexible economy, a stable government, the rule of law and a strong military. One by-product of U.S. dominance is the evolution of the dollar as a global "reserve currency." A reserve currency is a currency which is accepted globally as payment for goods and services. As an example, for many decades the global price of oil has been quoted in U.S. dollars.

A reserve currency carries many privileges. The easy facilitation and settlement of foreign trade is a prominent advantage. Government borrowing costs also tend to be attractive and U.S. treasury bonds are widely owned around the globe. Importantly, the position of a reserve currency is an important vote of confidence by global trading partners and investors, and this often translates into the ability to incur large, albeit temporary, deficits in trade (balance of payments) or in the management of the federal government's budget (fiscal deficits). Recent examples of these substantial deficits occurred during World War II and the financial crisis of 2008-2009. A key underpinning for the maintenance of a reserve currency is a dynamic and growing economy, along with sustainable fiscal and monetary policies. The post WWII economic boom allowed a robust increase in tax revenues, which had a positive effect on government deficits and also reduced the level of government borrowing in relation to GDP. In the aftermath of the 2008-2009 financial crisis, and the more recent COVID pandemic, the federal government has again experienced very large budget deficits which, for the current fiscal year, are expected to exceed $1.5 trillion. These deficits are occurring at a time when U.S. Government debt/GDP is projected to exceed 100%, which is the highest level since WWII.

Which brings us back to the dollar as a reserve currency. The maintenance of a reserve currency is a privilege and with that privilege comes the responsibility for government budget deficits and debt levels. With both U.S. federal deficits and government debt/GDP reaching modern era highs, the markets have been paying attention: the trade-weighted value of the U.S. Dollar has declined approximately 13% since the spring of 2020, while at the same time the price of gold has rallied over 20%. To be sure, the U.S. Dollar remains the world's foremost reserve currency. However, the dramatic increase in both the size of U.S. federal deficits and debt/GDP is being at least partially reflected in the recent weakness of the dollar. This is a development that bears close watching as it may have consequences for U.S.-based investors in the years ahead.

Changes

We have written frequently about the social, economic, and technological changes taking place and their potential effect on client investment portfolios. As we begin 2021, we wanted to highlight several important developments that may impact our clients this year and beyond.

- With both the presidential and congressional elections decided, the composition of our national government for the next two years has been settled. The President, and the Congressional leaders of his party have clearly communicated their priorities. Although the details are yet to be specified, we can expect significant change in tax, spending and regulatory policies from the new administration. This will be a meaningful change in direction from the prior four years.

- Inflation has remained largely quiescent over the last decade and the Consumer Price Index for December 2020 registered a year-to-year gain of 1.4%. However, we have recently begun to see a significant rise in industrial, agricultural commodity prices; the CRB Commodity Index rose over 11% during the fourth quarter of 2020. Given the large levels of monetary and fiscal stimulus expected in 2021, inflation trends will be top of mind for investors in the coming months.

- As mentioned, the overall stock market is trading at an above-average valuation level vs. recent history; the S&P 500 forward price/earnings ratio of 23 is above the 10-year median of 18.8. Considering the current low level of interest rates, the valuation level looks more reasonable; the dividend yield on the S&P 500 is currently 1.5% vs. the 10-year U.S. Treasury bond yield of 1.1%. Nevertheless, there are several reasons to be cautious regarding stock market valuation levels at the present time. A meaningful rise in the currently low level of interest rates would likely take a negative toll on the market's P/E ratio and stock prices in general. As we wrote last quarter, much of the stock market leadership in recent years has been concentrated in the "favored few" (the so-called "FANG" stocks as well as a handful of other high-growth companies). These companies currently constitute approximately 21% of the value of the S&P 500 Index, according to Strategas Research. Historically a trend of very narrow market leadership has not been sustainable indefinitely. Finally, signs of stock market speculation abound: these signs include increased speculative trading activity on retail investment platforms such as Robinhood as well as a robust issuance of initial public offerings including Special Purpose Acquisition Corporations (referred to as "blank check" companies in another era). Experience has taught us that amidst these signs of stock market speculation it is prudent to "set an anchor to windward."

How are we positioning our clients for these anticipated changes? As we discussed in our last letter, we have gradually been adding "straw hats in winter" to our client portfolios (solid companies, with above-average financial strength, attractive dividend yields and valuations). In tandem, we are paying special attention to choose companies that are positioned to manage in an environment of rising prices and/or interest rates. Our fixed income holdings continue to be high quality with average maturities of 2-4 years. Gold, in the form of gold iShares, remains a core holding in balanced portfolios.

As always, we welcome your comments and questions.