Investment Commentary

January 18, 2021

In the final quarter of 2020, the U.S. stock market returned 14.68%. This was in spite of election uncertainty, a worsening pandemic, high unemployment and delays in stimulus legislation. The financial markets are looking ahead to improvement in the economy later this year as vaccinations are rolled out.

While there is light at the end of the tunnel, global economic recovery is likely to be uneven. The outlook for asset class returns is mixed but overall positive.

The Economy

Continuing decreases in retail sales and higher unemployment numbers indicate a renewed downturn in the economy. Stimulus legislation was passed in late December and additional stimulus is forthcoming in the next few weeks.

Going forward there are two schools of thought concerning economic recovery. One scenario indicates a quick recovery due to pent up demand. Another scenario indicates a slower recovery due to a time lag in resurrecting small business. Once a vaccine has been administered to the bulk of the population, we are likely to see a bump from pent up demand. But a complete recovery will take longer. Big business will benefit from increased demand but small business will take longer to ramp up.

After a multi-year slide in the manufacturing sector, culminating in a big pandemic-induced dive, factory activity is rebounding. Inventories were drawn down during the pandemic as demand was greater than replacement of supply due to supply-chain breaks and factory shutdowns. Hopefully, this will continue, provided there are no more shutdowns.

Inflation

Inflation has been below average for the past twelve years or so. The historical average is 3.0% but has been below 2.0% for many years. The lower rate is indicative of slower economic growth. The Federal Reserve has a target of 2.0% and will keep short term rates low to achieve that goal.

In a different day and time, low interest rates, low taxes and a high rate of government spending would result in higher inflation. But that does not appear to be the case now. Inflation could continue to stay low for the next several years. Projected investment returns over the next ten years indicate Treasury Inflation Protected Securities (TIPS) will have about the same return as money market funds (0.6% to 1.6%).

International Trade

Trade issues will get a reset with the incoming Biden Administration. Other issues will be at the forefront so trade deals may not be part of the initial 100 day agenda. But a truce in the trade wars of the previous Administration will provide an opportunity to enlarge the U.S. manufacturing workforce and a boost to economic recovery.

The new Administration will work more closely with allies in confronting China on trade and is unlikely to roll back tariffs on Chinese goods any time soon. But a new development could be an impediment to cooperation. The European Union and China finalized a landmark trade deal on December 30th. This will be a roadblock in a unified effort to confront China on trade issues.

Brexit has been finalized and now Britain can pursue separate trade agreements. Lack of an agreement with the European Union has been an impediment to European trade for the past 4 ½ years. Trade can move forward now that the uncertainty has been lifted.

The Biden Administration will likely seek to resolve some of the more contentious issues, especially with allies, in an effort to target specific areas of our economy that need a boost. But trade issues have become more complex and negotiations, especially with China, will continue for years to come.

The Stock Market

The stock market has continued to perform well as it looks ahead 6 to 9 months and the eventual recovery in the economy. For 2021, returns will be modest due to valuation and slow economic growth. Small cap stocks have performed extraordinarily well in the past three months. And value stocks have outperformed growth stocks since early November. But it remains to be seen if this will continue or if growth stocks will once again outperform. Value and small cap stocks need a good economic environment to consistently outperform growth stocks. The market seems to be building in this scenario but it remains to be seen if it will continue.

International stocks have also outperformed the U.S. stock market since early November. They are undervalued as compared to U.S. stocks and also, U.S. investors have benefited since the Dollar is down as compared to other currencies (partially due to the extensive Federal budget deficit).

The “buzz” from the Biden stimulus plan has started to fade and the market is experiencing a healthy pullback after a strong rally since November. It is always the case that actual legislation that passes and is signed into law looks different than the initial proposals. But stimulus buzz could return as Congress works on the legislation. And there is the possibility of additional legislation later in the year.

Infrastructure legislation has been under discussion for years and has bi-partisan support. This is a priority for the Biden Administration and legislation could pass this year. While this is ultimately good for the economy and the stock market, there is a time lagged effect. Big infrastructure projects take years from initial development to completion.

The Bond Market

The yield on the 10 year U.S. Treasury Note drifted up from a low of about .50% last August to .92% at the end of last year. This year the yield has moved up and is currently 1.09%. It will likely continue to drift up over the course of this year as the economy recovers. Returns from the bond market will be very low this year and remain low over the next several years.

More than likely, if interest rates move up too much, the Federal Reserve will initiate another round of “quantitative easing” by buying bonds on the open market. This will have the effect of keeping rates within a reasonable range and avoid derailing economic recovery.

Real Estate

The residential housing market is performing well in spite of the potential for bankruptcies and foreclosures. Low interest rates on mortgages encourages buyers.

However, commercial real estate is not performing well. Closures of retail establishments, restaurants and other small, local businesses have led to an excess of empty space. And the current work-at-home environment has accelerated the trend of decreasing demand for office space. There is likely to be an oversupply of commercial space for years to come.

Real estate investment trusts (REITs) are undervalued and have underperformed the overall stock market over the past several years. But investment returns are likely to continue to be subpar as long as there is an excess supply of space.

Overall Perspective

Economic recovery and investment performance will ultimately be determined by the vaccine rollout. So far the rollout has not gone smoothly and will take longer than initially promised. But things could improve and some segments of the population could be vaccinated as soon as this spring. As more of the population is vaccinated, the economy will gradually re-open.