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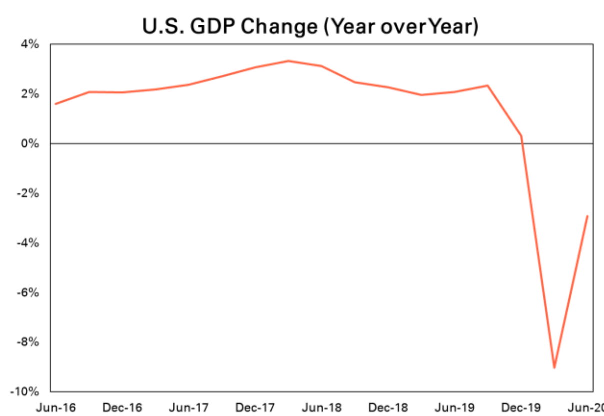
The Magical Equity Markets

As we sit here in the beginning of 2021, there are likely very few people wishing for a repeat of 2020. The global pandemic we experienced dramatically changed economic, social, political and cultural landscapes around the world and few would argue the changes were for the better. In the US alone, millions lost their jobs, thousands of businesses went bankrupt and a significant number of people succumbed to the virus. And yet the equity markets in the United States reached all-time highs. How did that happen?

The Pandemic's Impact on the Economy

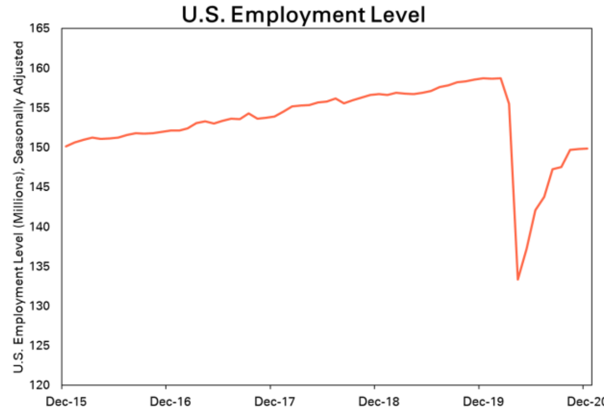
Covid-19 struck quickly in March 2020 and the lockdowns initiated in response to the pandemic led to a significant hit to global economic growth as one would expect. Travel was curbed, restaurants and other businesses closed their doors or reduced their services, and remote working became a household term. In the US, for example, these measures led to a significant drop in GDP, as shown to the right, that was the largest we have seen since the Great Depression.



Source: Federal Reserve Bank of St. Louis

And while the economy did rebound sharply from its lows in the second quarter, expectations are that real GDP growth in the US will still drop approximately 2.4% for the year[1]. Globally, it is expected that real GDP growth will end the year at roughly -4.2%[2].

This hit to GDP was accompanied by a significant surge in unemployment with certain areas, such as restaurants, hotels, retail and airlines, among others, reporting large layoffs (see chart to the right). While we have seen some recovery, the impact is still being felt and lockdowns continue. The December 2020 jobs report that was recently released saw an additional 140,000 people who lost their jobs, resulting in an unemployment rate of 6.7%[3].

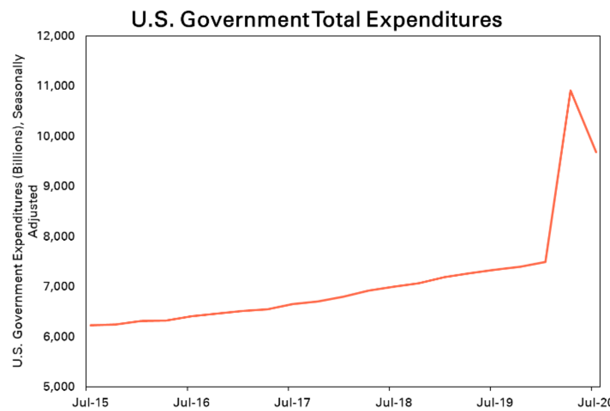


Source: Federal Reserve Bank of St. Louis

As one would expect, the widespread economic damage negatively impacted earnings estimates for corporations. Yearly earnings per share for the S&P 500 fell from 162.97 in 2019 to an estimated 135.67 in 2020[4], a drop of almost 17%. From an economic and corporate earnings perspective, it is rather surprising that the equity markets ended the year at all-time highs.

The Government and Central Bank Response

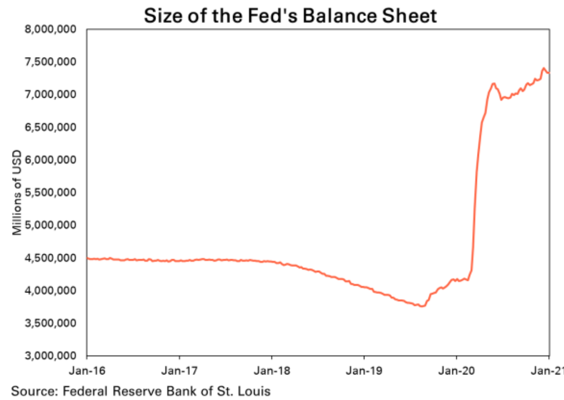
As a result of the situation outlined above, it is no surprise the devastation the virus caused to the economy was met with substantial government spending programs. The Cares Act, The Paycheck Protection Plan and numerous other assistance programs and bailouts led to a historic surge in government expenditures. The recently announced $1.9 trillion fiscal stimulus plan by the incoming Biden administration continues this trend[5].

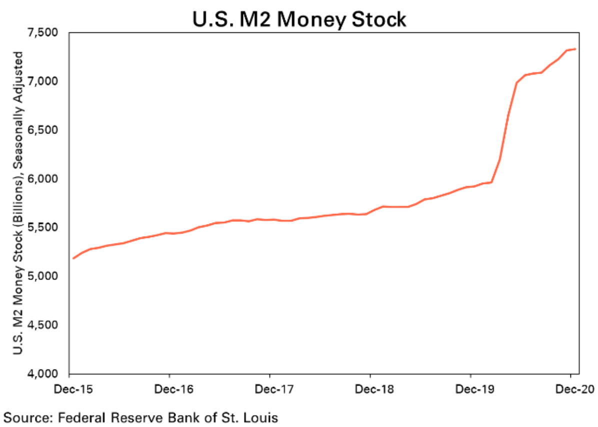


Source: Federal Reserve Bank of St. Louis

[1] Source: https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20201216.htm
[2] Source: https://www.oecd.org/economic-outlook/
[3] Source: The Washington Post, January 8, 2021
[4] Source: https://www.yardeni.com/pub/yriearningsforecast.pdf
[5] Source: https://www.msn.com/en-us/news/politics/bidens-aid-plan-could-revamp-economy-prompt-gop-resistance/ar-BB1cN6n5

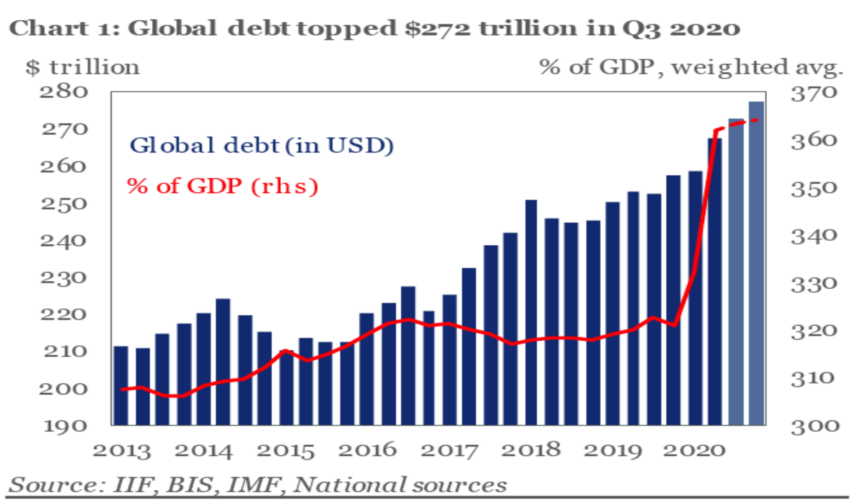
The Federal Reserve did its part too. No longer was it attempting to reduce the support program it had built up in response to the Great Financial Crisis in 2008. Instead, it reversed course and its support program ballooned as shown to the right. Furthermore, the Federal Reserve reduced its Federal Funds rate (the interest rate at which it allows banks to borrow and lend their excess reserves) from 1.55% all the way down to 0.05%[6].





Both of these factors, increased government spending and Federal Reserve asset purchases, led to one of the most dramatic increases in money supply we have ever seen as shown in the chart to the left. And some of that money found its way into the equity markets causing stock prices to rise.

Also, this was not the case just in the US. Governments and central banks around the world jumped on board with similar types of measures. As we can see below, global debt levels surged in 2020 and further expansion is expected in 2021.

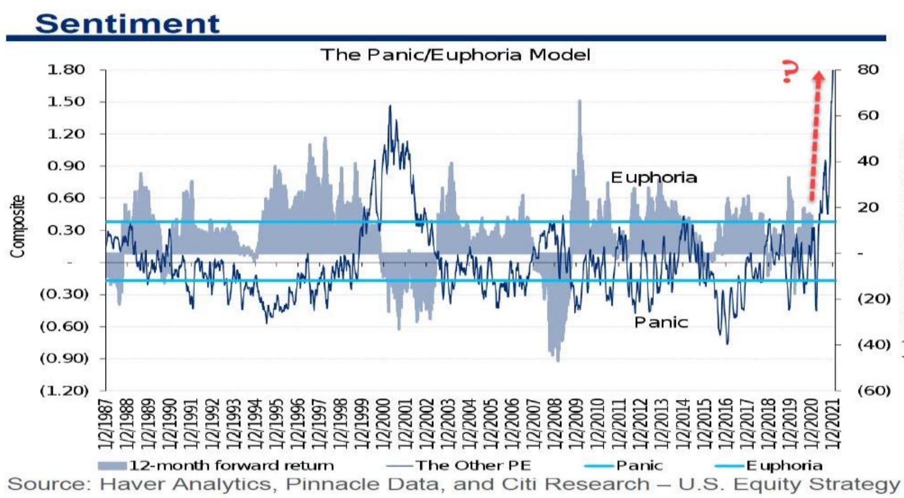


[6] Source: https://www.statista.com/statistics/187616/effective-rate-of-us-federal-funds-monthly/

Our Current Outlook for 2021

After such a strong run in the equity markets, capped by a very strong rally on the back of the conclusion of the US Presidential election and the initial rollout of Covid-19 vaccines in the fourth quarter, it would not be a surprise to see some notable volatility or a pullback and we enter the New Year on a cautious note. Whether or not the Covid-19 vaccines will be the panacea that everyone hopes for remains to be seen and, in the meantime, we are witnessing a significant rise in global Covid cases and deaths[7] accompanied by increasingly strict lockdowns that are negatively impacting global growth.

In fact, the World Bank recently reduced its expectations for global GDP growth in 2021 from 4.3% to 4%[8] and OPEC has lowered its global oil demand outlook by 350,000 barrels per day[9]. While these reductions may be modest, it does highlight the fact the coast may not be completely clear. Additional headwinds include the fact that we have historically high equity valuations to deal with as the S&P 500 trades on 21.8x 2021 earnings estimates vs. a historical average of 16.1x[10] and investor sentiment, as we can see in the chart below, is currently the most optimistic in decades:



We continue to pay attention to the risk in investor portfolios and manage them accordingly. While we greatly appreciate the occasional "magic" of the markets, these magical periods don't last forever and we prefer a disciplined and "grounded-in-reality" approach to managing our investors funds.

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[7] Source: https://www.nytimes.com/interactive/2020/world/coronavirus-maps.html
[8] Source: https://www.bloomberg.com/news/articles/2021-01-05/global-economic-outlook-dims-on-virus-s-surge-ahead-of-vaccines
[9] Source: https://www.reuters.com/article/oil-opec/opec-cuts-2021-oil-demand-outlook-again-as-pandemic-impact-lingers-idUSKBN28O1Y2
[10] Source: https://www.forbes.com/sites/jeffreyschulze/2020/12/17/high-us-stock-market-valuations-not-a-headwind/?sh=5d72e5281869

Lessons for Asset Allocation

The past year's volatility in the equity markets is a good reminder that sticking to a sensible, long-term asset allocation is important and that selling into a market panic is usually unfruitful. We prefer to view these roller-coaster market episodes as opportunities and continuously seek to maintain the overall risk within our clients' asset allocation guidelines.

If, though, the volatility of the past year made you particularly concerned, we would recommend giving us a call to discuss possible changes to your portfolio. It is important to consider adjusting your asset allocation when important changes occur in your financial situation or your risk tolerance. As always, we will continue to monitor the situation and invest prudently. We thank you for your continued support and look forward to working with you this year.

Chris Olson and Gautam Dhingra
January 20, 2021