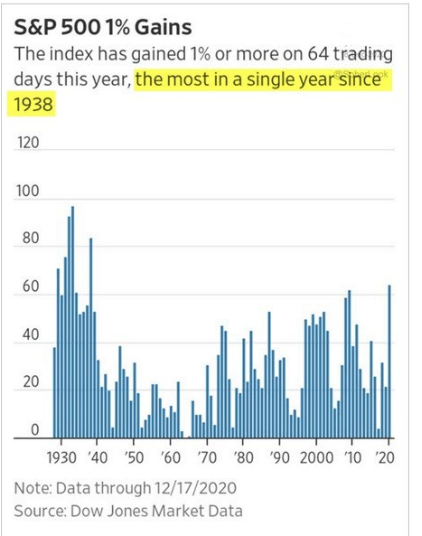
EQUITY MARKET UPDATE

As of 12/31/20 | Volume 9, Issue 12 | FFTAM.com

Stocks rallied further in December, and many indexes finished 2020 at record highs. Investors continue to be encouraged by government approvals for COVID-19 vaccines, while central banks around the world are providing large sums of liquidity and near record low interest rates. Finally, lawmakers passed over $900 billion in additional stimulus. Volatility remains high as COVID-19 infections are reaching daily record highs and mobility restrictions are being implemented in several parts of the world.

US Stocks Jump on Vaccine Approval and Stimulus

The S&P 500 gained another 3.84% in December and closed at a record high. The rally was once again broad based with all sectors advancing, except energy. Despite the far-reaching success, Apple accounted for 23% of the S&P 500's monthly move. Year-to-date, the index finished up 18.39%. As we have stated numerous times throughout 2020, the top eight technology-related companies—Apple, Amazon, Microsoft, Alphabet, Facebook, NVIDIA, PayPal, and Netflix—accounted for almost 50% of the total gains.



The Dow Jones Industrial Average performed similarly, increasing 3.41%. It also finished the year at record levels. Year-to-date, the Dow trailed the S&P 500 with a total return of 9.72%. A smaller allocation to technology, along with poor performance from Boeing has weighed on the index.

The NASDAQ jumped another 5.75% in December. Large gains in Apple and Tesla led to the outperformance. The NASDAQ was easily the best performer in 2020 with a total return of 45.06%. Like the S&P 500, the index got the bulk of its return from the eight largest mega-cap tech stocks and Tesla.

The best results in November were seen in mid and small-sized companies. The S&P 400 Mid-Cap Index gained 6.51%, while the S&P 600 Small-Cap Index zoomed 8.31%. They both benefited from having larger allocations to banks, energy, and industrial companies than their large cap peers. Year-to-date, both indexes still lagged with returns of 13.65% and 11.24%, respectively.

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International Markets Also Advance on Vaccine Approvals

Investor enthusiasm was also seen overseas. The MSCI EAFE Index increased 4.68% despite most of Europe and Japan tightening their restrictions to combat spreading COVID-19 infections. Despite the lockdowns, manufacturing data showed activity expanding in Japan, South Korea, Taiwan, and Germany according to IHS Markit PMIs. Service data, however, remained weak. The ECB increased the size of its bond buying program to €1.85 trillion. They also extended the purchasing period by nine months to March 2022. Finally, the EU and the UK reached an agreement on free trade. This enabled Britain to finally leave the European Union on December 31st; however, the deal only covers goods. The UK is primarily a service-based economy with dominance in financial services. These areas were not part of the agreement and still need to be negotiated. In 2020, the MSCI EAFE Index trailed its American peers with a total return of 8.39%.

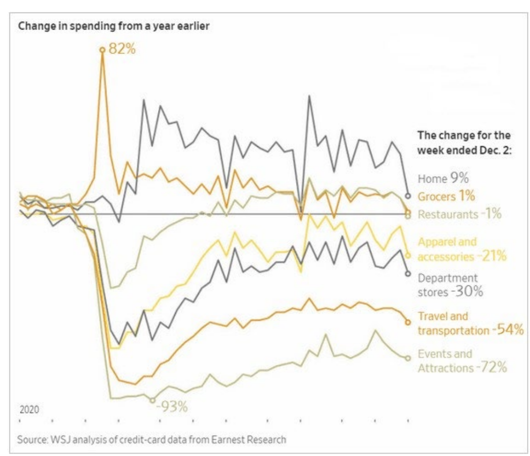
The Chinese economy continues to expand. Their December composite PMI was a strong 55.1. The report showed a slight deceleration in manufacturing with a reading of 51.9 versus 52.1 the previous month. Service-based PMI was 55.7, a slight decrease from November's 56.4, which was its highest reading since June 2012. China has been experiencing an improvement in retail sales as COVID-19 infections remain well contained. The positive economic readings caused the MSCI Emerging Markets Index to gain 7.25% for the month. Year-to-date, the index was up 18.50%. Geopolitical tensions continue to rise between the US and China. President-elect Joe Biden said he will maintain the Trump administration's tariffs on China, and he is planning to form a coalition with Europe and Australia to apply additional pressure on China in areas where they are in violation of WTO trade rules. The New York Stock Exchange also announced its plan to delist some widely held Chinese stocks in early January to comply with the Trump administration's order in November to bar US investment in companies affiliated with the Chinese military.

COVID-19 Vaccines Get Approved and Vaccinations Begin

Throughout the month, government officials around the world began approving COVID-19 vaccines for emergency use. The UK approved vaccines from Pfizer, Moderna, and Astra Zeneca, while China began administering a vaccine from Sinopharm for general public use. In the United States, the FDA approved the Pfizer and Moderna vaccines, and they are awaiting trial data from Johnson & Johnson. At year-end, only 2.8 million Americans had been vaccinated, far less than the 20 million that was planned. Government and medical officials are hoping to quickly ramp-up vaccinations in the new year after a mutation of COVID-19 was discovered in England. This variant is 70% more transmissible than COVID-19. In response, countries throughout Europe halted all flights from the UK. The new strain has already been detected in newly infected patients in China and the United States.

US Economic Data is Mixed as Infections Reach Record Highs

Many data points indicate the US economy is continuing to grow, but at a slowing pace, as COVID-19 infections rise across the country. Employment data has stalled, and the number of Americans who have been out of work for longer than six months is growing. More than 10 million of the 22 million jobs lost during the shutdown have not come back, and most of these jobs are in travel and leisure.



Retail sales shrank for the first time since April as people took precautions against rising COVID-19 infections. Convenience stores, clothing retailers, bars, and restaurants reported the steepest declines in monthly revenues. IHS Markit PMI data showed a slight softening in both manufacturing and services in December; however, both indicators are still in expansionary territory.

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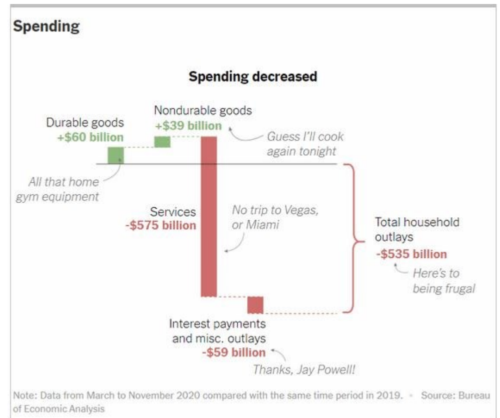
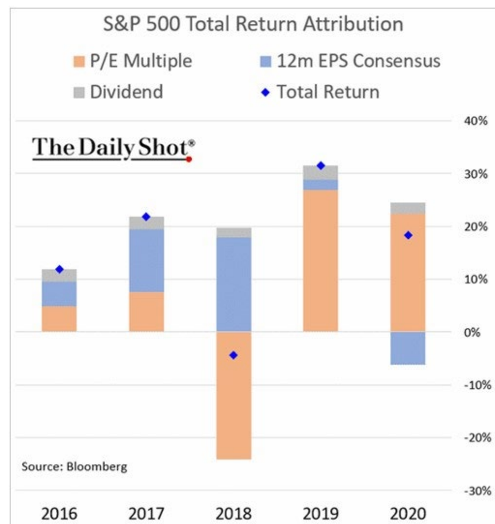
The Fed left interest rates at 0%, and they again reiterated that they have no plans to raise interest rates until the end of 2022 at the earliest. Congress approved a stimulus package worth more than $900 billion that would provide one-time $600 payments to most Americans, while also extending the $300 per week bump in unemployment benefits through mid-March. The bill also provided money for PPP loans to small businesses and aid for vaccine distribution. There is much debate on how stimulative this will be for the economy in the short-run since the Federal Reserve reported that more than two-thirds of the first round of stimulus checks were never spent. Also, the Bureau of Economic Analysis said total wages in November were back to pre-virus levels. The problem that plagues these stimulus programs is consumers continue to prefer experiences over stuff, and spending is not going to materially improve for the travel and leisure sector until vaccines are more widely distributed.



Rally Further Expands the Market PE Ratio

We are once again at the start of another earnings season. Analysts have raised their forecasts for fourth quarter earnings after companies solidly beat expectations last quarter. According to FactSet, Wall Street is expecting a 9.7% decline in year-over-year profits with the weakest results coming from oil and gas, restaurants and leisure, and airlines. Those three areas have consistently been weak since the start of the pandemic. However, with vaccines on the horizon, analysts have continued to raise their earnings forecasts for 2021 and 2022.

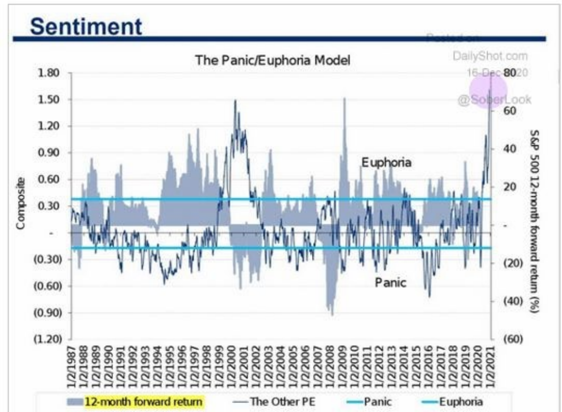


The market has rallied tremendously in anticipation of these improvements. The S&P 500 currently trades at 27.04x 2020 earnings estimates. Even if you fast forward to the 2021 and 2022 profit forecasts, the index trades at 22.11x and 19.07x, respectively. All these valuations are higher than the estimated PE of 19.02x we saw at the market highs in February before the pandemic. They are also well above the historical median of 15.33x. In fact, the only other time in history in which stocks were more expensive was 1999-2000.

When digging deeper into the data, some very important themes emerge. First, stocks appear expensive because we are at a very important crossroad economically. The economic shutdown forced people to use technology for so many of their daily tasks; therefore, investors flocked into these types of stocks. This caused technology valuations to balloon. Given the large percentage of the market represented by the technology sector, stocks naturally appear expensive. The pandemic also crushed the profits of economically sensitive companies, especially those who cannot operate because of the virus. Since these companies are currently unprofitable, it makes the PE look even bigger. This is why vaccine news is so important. Eliminating COVID-19 enables investors to broaden their portfolio exposures beyond tech stocks. If you examine the future earnings forecasts, the market is sharply divided. The high-flying tech stocks look very expensive, while the economically sensitive companies appear cheap as their businesses recover. The spread in valuation between growth and value stocks in future earnings forecasts is near the widest level in history; therefore, the rotation trade has room to run if the vaccines prove to be effective. There is one caveat. No one is sure how quickly the economy will recover, and they do not know how many of the habits formed during the pandemic will become permanent; therefore, these future earnings forecasts are highly subject to revisions.

Second, even if the current 2022 forecasts are correct, the market is still expensive when compared to history. Much of this is a function of low interest rates; therefore, stocks need an improving economy without much inflation.

Finally, investors are currently very bullish. The put-call ratio is at its lowest level since 2000, and most Wall Street firms have labeled the current market conditions as euphoric. Bitcoin zoomed over 300%, margin debt is at record highs, and we saw 454 IPOs in 2020, the highest number since 1999. Of these, 248 were SPACs, which are empty vehicles that raise money through an IPO and then use the money to merge into an unknown business. All these indicators signal the market has baked-in much of the upcoming improvements for the economy; therefore, stocks are vulnerable to consolidation or a pullback in the next few months. Given the amounts of cash still on the sidelines, any pullback will likely be quickly bought. Either way, volatility is likely to remain high.



Source: Haver Analytics, Pinnacle Data, and Citi Research – U.S. Equity Strategy

Our Outlook & Strategy

We believe the effects of COVID-19 will linger well beyond the time in which the virus is contained; therefore, the new “normal” will look much different than the world we saw prior to the virus. First, we have accelerated the time frame on the use and adoption of mobile technologies for education, shopping, entertainment, etc. We have also adapted to a non-centralized workforce. This will put pressure on commercial real estate values as office footprints and the number of retailers shrink. Next, companies across a wide range of industries have seen the risks associated with having too much manufacturing capacity centralized in China. There are likely to be serious conversations in board rooms across the US and Europe on whether several regional points of manufacturing are better for business and political relations than supplying the entire globe with products from a single country of origin. A shift from the current model will have significant ramifications for the future growth of the Chinese economy, along with the cost of goods and services sold. With the world fully dependent on scientists to create therapeutics and a vaccine for COVID-19, we believe future healthcare spending will increase as we replenish healthcare supplies used during the pandemic and boost R&D to solve other illnesses. Finally, these structural changes, along with the large stimulus responses from global central banks and governments will result in 0% interest rates for a very long period.

Given these various scenarios, along with above average valuations, we remain highly selective about which stocks to own. We favor companies benefitting from the long-term secular trends mentioned above, along with a mixture of financially strong cyclical and defensive stocks that can produce top-line revenue growth and sustainable cash flows during the next economic cycle.