WHAT NEXT?

"Welcome to the Roaring '20s. When the world finally bids farewell to COVID-9, courtesy of a bevy of novel vaccines. Just don't expect the party of Main Street to spread to Wall Street, which had a rollicking celebration of its own over this past year. As a consequesnce, stock prices are now sky-high, speculation is rampant , and the good news, as they say, is firmly backed into many shares. For stocks it should be a Boring '20s, or at least a muted 2021. That's the rough consensus of the 10 investment pros on the Barron's Roundtable who met on January 11 to parse the prospects for investors, the economy, the country and the world in the year ahead." (This is a quote from the *Barron's* issue of January 18, 2021.)

Catherine Mann, Chief Global Economist at Citibank, appeared on Bloomberg on January 27. She said that Citi's opinion is that if you look at the vaccine, rollout of the vaccine, stimulus, low interest rates, the economy opening back up and a pickup in human activity like links in a chain the links all line up. The market assumes everything will be great going forward. Citi thinks that the vaccine will not result in herd immunity until the end of 2021. She thinks that the market will be disappointed when the economy does not open as fast as everyone thinks. When there are pull backs in the market investors are realizing to some degree that the economy is not keeping up with the market.

The Federal Reserve accounced on January 27 that it will keep the Fed Funds rate at 0%-.25% indefinitely and will continue to buy $80 billion of treasury securities and $40 billion of mortgage backed securities each month indefinitely. It said that the path ahead for the economy is "highly uncertain". The unemployment rate stands at 6.7%. They said that fiscal stimulus and low interest rates are helping, but the virus will determine the future economic recovery. Consumer prices went up during the summer but have slowed since. The Fed would like inflation to rise to 2% and will let it go higher for a while if it gets there. The real estate market has done well because of low interest rates and people desiring to leave the large cities.

<u>Hoisington</u>

The overwhelming judgement of market forecasters is that interest rates will rise throughout 2021 because of the expectation that additional fiscal stimuluses compiled with an easy monetary policy will create an inflationary cocktail as pandemic related shutdowns lessen.

Hoisington disagrees! Their rationale is as follows (from the Hoisington Investment Management Company "Quarterly Review and Outlook Fourth Quarter 2020"):

(1) Massive void in economic activity and destruction of wealth created by the virus and related shutdowns of businesses in the U.S. and abroad will take years to fill.
(2) U.S. fiscal multipliers are generally negative resulting in government spending being counterproductive in stimulating the economy. Government spending does not get the economy going. Short term effect.
(3) Monetary policy becomes much less impactful since the debt overhang was massive before the pandemic and is now even worse.

Debt Drag

When government debt to GDP gets over 60% the economy starts to slow down. Debt to GDP at the end of 2020 was 127%. The total public (government) and private debt to GDP was 410%. This is higher than the 300% during World War II which was a record until now. This also slows the economy. Congress is in the process of increasing the debt even more.

The ever insightful economist David Rosenberg recently noted a few more statistics which reflect the magnitude of the devastation over the last 12 months: 1) government benefits now account for nearly 20% of total personal income; 2) one in four households haven't been able to meet their monthly bills since March; 3) one in 15 homeowners are in some sort of loan forbearance relief plan; 4) 75% of the government stimulus went to debt paydown and savings; 5) one in three households dipped into savings or retirement accounts over the past year and one in six has borrowed from family or a friend to cover bills. Additionally, it should be noted that the National Multifamily Housing Association found that over three quarters of households made full or partial rent payment for the month ending December 6th, down almost 8% versus last year. Specific industries are reporting catastrophic declines as typified by the National Restaurant Association warning that "more than 500,000 restaurants are in free fall." The same might be said of other entertainment venues and services industries. The severity of the downturn has decimated many small businesses and they may not survive in their former state. As is also the case for office buildings, shopping centers, convention facilities and airlines.

Because of the destruction of small businesses, the fact that fiscal expenditures have a negative multiplier in the economy, the debilitating impact on economic growth of excessive debt to GDP, and monetary stimulus, a secular inflation cycle is not at hand. <u>They think interest rates will go lower as the economy does not recover as quickly as some think.</u>

<u>The Stock Market</u>

As of January 27, 2021, the *Wall Street Journal* reported the S&P 500 trailing P/E Ratio was 41.74X and the projected P/E Ratio 23.42X. The Nasdaq trailing was 41.10X and projected 30.98X. The Dow trailing was 29.47X and the projected 23.55X. FactSet Earnings Insight published forward estimates and valuations for the S&P 500. Its latest from the January 15 issue are listed below:

Earnings: Analysts Expect Earnings Decline of -13% for CY 2020

For the fourth quarter, S&P 500 companies are expected to report a decline in earnings of -7.2% and growth in revenues of 0.2%. For all 2020, S&P companies are expected to report a decline in earnings of -12.9% and a decline in revenue of -1.7%.

For CY 2020, analysts are projecting earnings decline of -12.9% and a revenue decline of -1.7%.
For Q1 2021, analysts are projecting earnings growth of 16.8% and a revenue growth of 3.9%.
For Q2 2021, analysts are projecting an earnings growth of 46.3% and a revenue growth of 14.2%.

For CY 2021, analysts are projecting earnings growth of 22.5% and a revenue growth of 8.1%.

Valuation: Forward P/E Ratio is 22.4, Above the 10-Year Average (15.7)

The forward 12-month P/E ratio is 22.4. This P/E ratio is above the 5-year average of 17.5 and above the 10-year average of 15.7. It is also equal to the forward 12-month P/E ratio of 22.4 recorded at the end of the fourth quarter (December 31). Since the end of the fourth quarter (December 31), the price of the index has increased by 1.1%, while the forward 12- month EPS estimate has increased by 1.2%.

At the sector level, the Consumer Discretionary (37.1) and Energy (32.6) sectors have the highest forward 12-month P/E ratios, while the Financials (15.3) sector has the lowest forward 12-month P/E ratio.

All are above their historic averages.

Using the Russell 1000 Growth and Russell 1000 Value indexes P/E Ratios, Growth stocks are 1.72X more expensive than Value stocks. Growth stocks like Apple, Google, Microsoft, and Facebook are the types of stocks that have led the market in 2020. We are experiencing a stock market “bubble” caused by the lockdown of the economy with people working from home and low interest rates. Last year the market rose because of P/E expansion as earnings and revenue fell. It can happen the other way quickly.

Conclusion

The party in the market can continue a little longer as new stimulus is passed by Congress and the Federal Reserve continues to keep interest rates low and money supply high. We do not know when the party will end, but we do know it will. If the economy does not open dramatically in the second half of 2021 then look out below. When monetary policy and fiscal stimulus along with an overvalued stock market happen, it is a formula for a bubble in the stock market. This could be the biggest bubble of all time.

We are not recommending any changes to our current asset allocation of 40% stocks and 60% bonds/alternatives. We will be recommending rebalancing to that allocation if the market takes stocks higher.

Jamison Monroe
Chairman & CEO
Director of Consulting

Monroe Vos has over $5.5 billion under advisement for 100 clients. Recent rankings are as follows:

- The 3rd largest independent registered investment advisor ("RIA") in Texas
- The 8th largest independent RIA in the Southeast
- The 60th largest independent RIA in the United States

As reported by *Financial Advisor* magazine in August 2020

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