ALEXANDRIACAPITAL

Outlook Memorandum

January 2021 • S&P 500: 3757

Jonathan Ferguson, CFA
Chief Investment Officer

SWIMMING IN LIQUIDITY

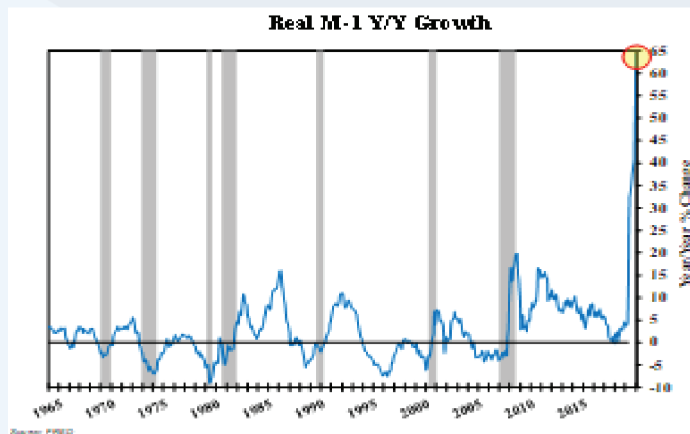
While there will be many entries into the history books dissecting events of the past year, the paradox of a rising market despite deep economic scars, unprecedented political polarization, and rising infection rates reflects a powerful force at work: money supply, adjusted for inflation, rocketing a massive 60% higher during 2020. It is hard to fathom the vast quantity of money mobilized by the Fed in response to the pandemic, but ultimately all that money had to be redeployed somewhere. Some of it indirectly funded stimulus payments, enhanced unemployment benefits, and forgivable business loans – which provided much needed support for some households and businesses, and a windfall for others. A large portion was recycled back into markets (stocks/riskier bonds), with a renewed passion for investing highlighted by the surge in new accounts at upstarts (Robinhood) and industry stalwarts (TD Ameritrade/Schwab).

The reality is monetary policy is far more art than science, far more blunt than precise. With the financial system flush with cash, market gains accelerated in the fourth quarter as investors adopted a more confident outlook for 2021, driven by the expanding repertoire of potent COVID treatments (including highly efficacious vaccines from Pfizer and Moderna), the Fed's steadfast commitment to highly accommodative monetary policy, and additional rounds of stimulus checks/enhanced unemployment benefits. For the year, the S&P 500 gained over 18% (a 70% rally off its pandemic low). Tech stocks led the charge, rising over 45% in 2020, while hospitality, travel, energy, and portions of the real estate sector were down double digits. Overseas, Europe lagged, returning about 6% for the year. In Asia, Japan gained over 14%. Emerging markets pulled roughly even with U.S. markets thanks to a rally late in the year. Bonds did well, returning about 7% as interest rates fell, while industrial commodities spiked higher on bets that government stimulus spending, globally, will be forthcoming. Gold also rallied as investors increasingly embraced strategies that might hedge the impact of global monetary policies.

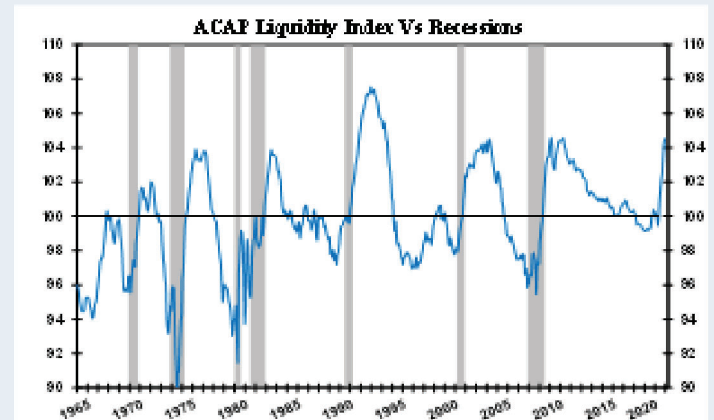
2021 should be less eventful than the past year as an economic recovery drives a strong rebound in corporate earnings, though market gains may be more muted due to high valuations today. A subtle but important pandemic development has been the coincidental coordination of policy between the Fed and Congress. Assuming no major setbacks or delays in rolling out vaccinations, the need for expanding the money supply at exceptional growth rates will dissipate – credit spreads are already tight amidst trepidation over speculative investor behavior. At the same time, income/wealth inequality, exacerbated by the pandemic, is prompting successive fiscal stimulus to concentrate more toward helping those hit hardest by the shutdown – a deliberately "bottom-up" calibration that stands to channel the power of monetary policy more directly into the real economy through fiscal spending, as opposed to the "top-down" impact of cheaper borrowing rates and wealth effects. This coincidental policy coordination tilts the inflationary potential of stimulus from asset markets to the economy (goods and services) and strengthens the cyclical outlook. Interest rates and inflation expectations have already been rising in anticipation that vaccines will lead to fewer restrictions and unleash pent-up demand primed by prior stimulus. As a result, markets are anticipating a cyclical recovery that will drive a robust profit recovery, particularly among the sectors that suffered the most (hospitality, financials, travel, energy). While valuations among cyclical sectors have room to expand, our overall outlook is tempered by the high-flying tech valuations that led the market higher over the past year (and stand to be more sensitive to rising interest rates and inflation expectations).

There is no debating the fact the pump is fully primed. Policymakers have followed a path more concerned with saving the system than achieving fairness – a reality that saw the Fed and Congress flood the financial system with over $5 trillion in an all-out effort to ensure solvency across the entire economy as job losses and business failures soared. During typical recessions, rising unemployment becomes self-reinforcing as households curtail spending and fall behind on loan or credit card payments, which in turn leads to lower business revenues, a further reduction in jobs, and so on.

The pandemic shutdown put almost 25 million people out of work in a matter of weeks – almost four times the cumulative total job losses during the Great Recession. Unemployment benefits typically dampen the impact across the economy, but this magnitude of disruption required massive intervention. The Fed's efforts very much required action that provided an unmistakable signal to investors: disregard the moment and take note the Fed would inject enough cash to enable borrowers across the credit spectrum to refinance. The surge in real M-1 money supply, rising 60% from the prior year as the Fed rapidly hoovered up bonds, provided exactly that signal and support.



In lockstep, Congress enhanced unemployment benefits, and provided stimulus checks and forgivable business loans. Normally, such monetary and fiscal stimulus, equivalent to almost 25% of GDP, would be expected to mobilize "animal spirits" and translate into an inflationary acceleration in economic activity. Bold, confident action returned to financial markets, including clear instances of speculative behavior that echoes some of the head scratching dynamics of the dotcom era – but widespread restrictions on everyday activities (mandated and self-imposed) blunted the impact on Main Street. Household savings rates soared above 30% with the initial stimulus measures back in April and May as people either conserved cash out of caution or a lack of spending outlets. The savings rate remained elevated through year end, and we will likely see another spike in savings with the next round of fiscal programs.



Banks have an increasing capacity for lending as policymakers keep stimulating. The combined stimulus actions have caused cash balances to balloon across the financial system, even with the clear uptick in retail market participation – JPMorgan's deposits increased 35% last year, with similarly large increases among other banks. Deposits are typically loaned out to consumers and businesses (otherwise they represent a drag on bank profitability) – but woefully small amounts have been deployed toward lending activity recently, which is not surprising given the rate of business failures and the lack of viable expansion opportunities (why would a restaurant borrow to open new locations?). Still, the surge in deposits represent future lending potential as the economy begins to grow again – and the impulse for lending could be a powerful economic driver as lenders, households, and businesses evaluate opportunities in the context of prospectively more impactful stimulus in the quarters ahead (that is stabilizing the inflation outlook already, with an upward bias) and a reopening of the economy. This dynamic of rising capacity for lending is captured by the sharp upward spike in our ACAP Liquidity Index, which signals growing pressure within banks as deposits continue to rise (the lack of lending must either lead to an acceleration of loans or a halt in the surge in deposits).

All Eyes on the Vaccine Rollout. The contours of daily infections and hospitalizations have been the focus of shutdowns and restricted economic activity since March. Some sectors have clearly thrived in a work-from-home environment as many

households enjoyed extra disposable cash due to stimulus efforts amidst savings on commuting, eating at home, and lower cost leisure activities. These spending shifts are evident in the latest data from Open Table, for example, which indicates the number of seated diners is down over 50% (and that is only accounting for restaurants still in business), while TSA's tally of air travelers passing through security is stuck 60% below last year. The ranks of the unemployed remain unfortunately distressed at over 10 million individuals. Moreover, new weekly claims for unemployment benefits are stubbornly high at over 900,000 – which is 50% higher than the worst week back in 2009.

Stimulus efforts undoubtedly prevented a deeper downturn – but the mobilization of all that cash accumulating within the financial system is unlikely until more than 60% of the population has been vaccinated (bringing overall immunity north of 70%), which should enable more normal social activity and lifting the restrictions that have weighed on businesses, jobs, and consumer spending. The vaccine distribution has been slow in the early stages, reflecting both availability and complicated logistics. Less appreciated is the sharp downward trend in net new COVID hospitalizations and ICU usage year-to-date. To be clear, this is not indicative of vaccinations (yet) and probably reflects the broader availability of better treatments. The urgency to reach these levels of immunity (by mid-year) has intensified as new strains of COVID-19 have been identified. Thus far, the approved vaccines remain effective against these new strains and the science behind the Pfizer and Moderna vaccines lends itself far more easily to modular adaptation if they need to be tweaked in response to a future strain that emerges (implying a much shorter timeframe).

The vaccines set the stage for a steady, organic build in economic activity throughout the year. Some hints of pent-up demand and a desire for normalization of activity have already surfaced, including higher than normal bookings for cruises, destination vacations, and theme park visits later this year, which fits with the general timeframe in which infection risks may reasonably be expected to diminish.

Longer term, emerging policy coordination may deliver more balance. Historically, the Fed sets monetary policy and Congress determines fiscal/industrial policy – lines that are not crossed, even during recessions when the Fed only implores Congress to do more. What feels different now is the pandemic significantly worsened the long simmering income/wealth inequality – to the point that fiscal policy, with the Fed's explicit support, is taking a shape that, at least transiently, aims to narrow that divide. This represents a necessary departure, given the circumstances, from the policy frameworks of the past forty years, which generally protected business profits and prioritized price stability as the primary mechanism for promoting employment and prosperity.

Addressing inequalities, broadly, has a growing base of political support. In recent years there has been a growing chorus of the uber wealthy (billionaires) advocating for more progressive tax and entitlement policies – with increased urgency and support following high profile social injustices and the stark divide created by the pandemic. The "top-down" bias to historical monetary, tax, and industrial policies have not coincided with uniform gains in prosperity for all demographic groups even before the pandemic (the reasons are complex and include asymmetrical impacts of monetary policy and the effects of globalization, in addition to policies overseas). Labor's share of the economy has declined over the years (to a multi-decade low), while corporate profits have risen (multi-decade high). Some of the same dynamics underly the inability of recent trade tariffs to exert any impact on the U.S. trade deficit. China just registered its highest trade surplus ever in 2020 as U.S. stimulus significantly leaked overseas.

> Some sectors have clearly thrived in a work-from-home environment as many households enjoyed extra disposable cash due to stimulus efforts amidst savings on commuting, eating at home, and lower cost leisure activities.

Change is on the margin. While politicians and fiscal policies are leaning toward recognizing and intervening in these inequalities, we note fear of inflation has dominated the thinking of the Federal Reserve and economists since the 1970s. A repudiation of the historical ideology is neither in the

cards nor necessary. Still, over the past year Congress has flirted with adding income equality as a third mandate for the Fed. At first blush, easier said than done, unless the Fed is to venture into industrial policy and extend loans to favored sectors or socio-economic groups (which would pre-empt Congress' power to set policy). However, the Fed's tacit acceptance of this responsibility may manifest as a reluctance to raise interest rates and choke off incipient inflation pressure if such pressure is originating among lower income jobs and households (when in the past, the Fed may have done exactly that). Early consequences of such potential policy evolution may be underway as mortgage rates are now lower than the growth in average hourly earnings (wage growth is increasing 3-4% while 30-year mortgage rates are below 3%).

The necessity of targeting fiscal stimulus to households lower on the income ladder as part of the pandemic response may work well and be politically rewarding. But this does not mean there will be a wholesale ideology overhaul at the Fed or within Congress – rather, we are pointing out that after many years in which policy favored investors and nurtured rising inequality and imbalances, the pandemic has created the year conditions where more directly lifting the fortunes of those Americans lower on the income/wealth totem pole is urgently necessary. This introduces the possibility that inflation is more balanced between asset markets and the economy, disposable income growth is more balanced across socio-economic segments, and a more stable inflationary environment emerges (which would be a departure from the disinflationary backdrop of the past four decades). Importantly, if this comes to fruition, it is not an either-or outcome for investors, but rather a balancing in the split of economic benefits and implies that while interest rates and inflation may rise over time, so will earnings, and asset prices would be expected to perform more in line with earnings growth as opposed to ever higher valuations as interest rates fell.

> For investors, corporate earnings and valuation prospects are brightest for those sectors that struggled the most over the past year, including leisure, hospitality, and financials.

Looking ahead, we see the prospect of additional coordination between monetary and fiscal policies as an important development that can strengthen and extend the cyclical outlook upon achieving broader immunity across the population. While this will inevitably result in an upward bias to inflation and longer-term interest rates, we do not expect the Fed to abandon its inflation fighting ideology in any form. For investors, corporate earnings and valuation prospects are brightest for those sectors that struggled the most over the past year, including leisure, hospitality, and financials. Importantly, while the pace of innovation across biotech and tech (and their industry adjacencies) is accelerating, many valuations are optimistic – with stock prices that now require investors to pay upfront for all the potential some of these companies may prospectively deliver in five to ten years. Interestingly, dividends continue to garner comparatively less enthusiasm from investors despite the scarcity of income opportunities in global markets. Ultimately, we view the macro backdrop as supportive to stocks over the next twelve months though not to the levels we have experienced over the last two years given higher valuations, especially among the biggest winners of 2020. In fixed income, we continue to prefer high quality and shorter-term maturities.

AlexandriaCapital.com | 800.500.4647
Arlington VA | New York NY | Boston MA | Portland OR | Juneau AK

Connect with us:

Wealth | Investment | 401K
SOLUTIONS

This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, investment, financial, tax, legal or accounting advice. You should consult your own financial, investment, tax, legal and accounting advisors before engaging in any transaction.