04/2021

2021 First Quarter Newsletter & Outlook

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Looking back at the first quarter of 2021, and at the economy of the last year, it feels as if the word "unprecedented" has lost its shock value. An assault on the US Capitol building, a US president's second impeachment and Senate trial, record-shattering deficits, $4 Trillion in Federal economic stimulus measures in response to a modern-day global pandemic (that has claimed over a half million lives in the US alone), Georgia electing a Black Democrat to the US Senate, civil unrest, a record-breaking stock market turnaround – that and more in the last 12 months.

Charting a prudent course of action (my job) in the context of our mission to: 'Transform money from a source of worry to a resource for fulfillment' has never been harder, nor more frustrating. I detest being forced into in zero percent cash and scrapping for puny bond yields while trying to weigh the least bad state of worry my clients could be in (see page 6: "Getting Higher Returns on Cash").

In the first quarter of 2021 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 0.55%, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) gained 6.17%, and the Barclays Aggregate Bond Index lost 3.37%. The range of MCS individual client returns was from a gain of 2.2% to a loss of 1.6%.[1]

Two clients with the lowest returns had a significant allocation to a legacy stock, which underperformed in Q1 after an excellent 2020 return. Clients with the highest returns had higher US equity exposure but did not own that stock. MCS client returns were protected from the bond market pullback by the focus on short term bonds, which did not decline in price.

The 2020 stock market metamorphosis from bear to bull market extremes was unprecedented (See Figure 1 and Table 1). Market pundits are sagely 'splaining how 'rational' this all is, what with all the government stimulus and assurances of low interest rates propping up the economy combined with corporate debt borrowed to get through a global pandemic that isn't exactly going away.

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Figure 1

A Stock Market Recovery Like No Other

Source: Dow Jones Market Data, Wall Street Journal

Table 1

Stock Market Recoveries

All-time high	20% below all-time high (Bear market)	Days from all-time high to Bear market	Back to all-time high	Days from minus 20% to new all- time high	Maximum loss
08/03/1956	10/21/1957	444	09/25/1958	339	21%
12/12/1961	08/01/1962	232	08/30/1963	394	28%
02/09/1966	10/03/1966	236	05/03/1967	212	22%
11/29/1968	01/19/1970	416	03/03/1972	774	36%
01/11/1973	11/27/1973	320	07/16/1980	2434	48%
11/28/1980	02/22/1982	451	11/02/1982	253	27%
08/25/1987	10/19/1987	55	07/25/1989	645	34%
03/24/2000	03/12/2001	353	05/29/2007	2269	49%
10/09/2007	07/29/2008	294	03/27/2013	1702	57%
02/19/2020	03/12/2020	22	08/17/2020	158	34%
Median		**307**		**520**	**35%**

Source: Forbes Magazine March 2020; MCS

Based on my research, and as I wrote about in last year's Q2 newsletter, the consequences of natural disasters are profound and long lasting. Entire business ecosystems are being permanently disrupted.

For example, no previous recoveries have left businesses contemplating reducing their office space in mass to accommodate a new paradigm of work from home. While it's true that office leases will maintain cashflow for several years, the market will reprice those buildings downward to reflect falling lease rates, hence falling property values. For shopping malls, first it was lease rates and then bankruptcies, which the pandemic greatly accelerated.

The top 10 US cities accounted for 34% of GDP in 2018. A migration of knowledge workers to alternative locations based on affordability and quality of life decisions could have a major impact on city finances, real estate holdings, and the many city businesses that support those worker concentrations. Think about the disruption that the internet and companies like Amazon have caused to the Shopping Mall real estate model. With online shopping, you don't need to 'commute' to buy stuff. Why a daily 'commute' to the office, when we now know that many people don't need to be in the office every day to get the job done?

Deciding on the best strategy is complicated by a lack of pandemic related historical economic data, although there is familiar and plentiful 'hysterical' data in the form of investment frenzies. Crypto-currencies, SPACs (Special Purpose Acquisition Companies)[2], and the GameStop 'short squeeze' are flashing like bright warning beacons on top of a stock market whose valuation is at historical extremes.

With the caveat that valuation offers no clues about timing an exit, here's Warren Buffet's favorite valuation measure: Total Market Cap (value) to GDP (Gross Domestic Product). Based on these historical valuations, we are well beyond the highest zone threshold.

Table 2

Warren Buffet's Ratio: Total Market Capitalization to Gross Domestic Product

Total Market Cap / GDP	Valuation Measure
Ratio ≤ 74%	Significantly Undervalued
74% < Ratio ≤ 95%	Modestly Undervalued
95% < Ratio ≤ 116%	Fair Valued
116% < Ratio ≤ 137%	Modestly Overvalued
Ratio > 137%	Strongly Overvalued
As of 2021-04-18: Ratio = **204.2%**	Strongly Overvalued

Source: https://www.gurufocus.com/stock-market-valuations.php

The website https://www.currentmarketvaluation.com offers five stock valuation models including the above: three indicate ‘Strongly Overvalued’ and two indicate ‘Fairly Valued’. The Fairly Valued models are dependent on current low interest rates.

One argument supporting the continuation of the bull market is debt servicing costs are what really matters. With interest rates so low, the debt servicing costs are not a problem (which is true — for now.)

The big risk is that increases in inflation, interest rates, and debt levels can be self-reinforcing. Higher inflation increases interest rates which increases debt costs. This makes heavily indebted sectors like airlines more likely to default.

Inflation Management Game Changer

Many market participants are concerned that efforts to rescue the economy from the pandemic recession will lead to higher inflation (see page 7, “What About Inflation?”). The Fed has assured investors that it does not believe this will be the case. Investors are betting the Fed is going to keep interest rates low enough to not impair the bull market.

To add to the uncertainty, the Fed’s method of managing inflation for the past 40 years has just changed entirely. The Fed had to change it. All their research / theories about what ignites inflation and hence how to put that fire out before it got raging – yeah, applying that did not work, especially in the last decade.

The Fed believed that once unemployment got too low, inflation would pick up (the famous wage / price spiral of the 1970’s to early 1980’s; prices go up / wages go up / repeat).

Fed economists made up a concept called NAIRU (non-accelerating inflation rate of unemployment). The Fed then based their interest rate increases on what they believed (it couldn’t be observed) was the lowest rate at which unemployment could decline before a wage / price spiral got started. The problem is the Fed has no idea what that non-inflationary unemployment rate is, or if it really exists, or if it only exists under certain conditions.

So, the Fed has a new strategy – wait until inflation is running hot for a while and then cool it off. The goal is to have an average inflation rate of 2%. How hot and for how long to get to the 2% average is a mystery. Here’s an analogy:

> *Imagine a bathtub with water that is too cool. You want to warm it up to ‘just right’, but the hot water temperature varies, and you don’t know how much hot water is available. There’s also a chance that the faucet might get stuck and you would not be able to shut it off quickly. Good luck with getting to the Goldilocks temperature you want.*

As news sources remind us, the global pandemic is not over. I am so glad to be vaccinated, but it sounds like booster shots are in my future. I wonder – how many? For the US stock market, the pandemic is yesterday’s news. I hope that’s right, but it’s staying on my radar as a risk that merits continued surveillance.

The Bottom Line

Prudent: *adjective*

acting with or showing care and thought for the future

1. **a**: marked by wisdom or judiciousness
   prudent advice
2. **b**: shrewd in the management of practical affairs
   prudent investors

Sources: Oxford and Merriam-Webster Dictionaries

After a year of pandemic, I understand the psychology of wanting to celebrate the end of a very difficult period. After feeling your life might be at risk, the ebullient mood of the financial markets is a very strong draw – appearing as something very positive to join in. Who doesn't want 'positive' and the prospect of making money too??

If you were responsible for someone's life savings, what is a prudent investment strategy in a pandemic to post-pandemic world? Do you go with the flow? Accept the experts' view while knowing the experts are selling something?

What I do know is that, based on the historical data (see valuation comments on pp 3-4), markets are very expensive. Those heavily invested at times like these do poorly over the subsequent 10- to 12-year time frame.

Could this time be different? Yes. Is it prudent to bet that it's different? I do not believe it is.

For those who feel strongly about getting more exposure to the stock market, I am customizing their portfolios to meet those desires. While they are taking more risk, it is not excessive in the sense it will be a threat to their financial well-being (I would strongly object to that level of exposure).

If you feel you'd like more exposure to stocks, please contact me. I can change your investment allocation to accommodate that!

If you leave the decision to my judgement, I want to see this pandemic-inspired bull market play out longer while taking some baby steps into more stock exposure. I believe:

- The pandemic has permanently damaged / altered some parts of the economy
  - Financial aid has papered over the problems – problems that will return. Think of airlines, cruise ships, and autos…
  - Work from home will permanently change:
    - Commercial real estate demand
    - Automobile Industry – a major reduction in commuting/ mileage/ car replacement
    - Major city downtown economics
    - Lesser city downtown economics
  - The Fed's low interest rate policy will not solve the above
- The pandemic has distorted demand for goods and services and it's hard to say what the normalized trends will look like

The reason I encourage clients to have no debt and invest conservatively is because it is a highly resilient position to be in. Investors dodged a potentially devastating portfolio bullet in 2020. Now, too many behave as if it never happened.

Bottom Line

You don't lose money by waiting for better opportunities. Investing is akin to running a 50-mile ultra-marathon. Your position in the downhill section from mile 22 to mile 32 is not going to determine your finish even if a lot of people are passing you at that point. What will determine your finish is your resilience / conditioning when the big hills come.

I am sure that you appreciate the world has just changed in ways that were unforeseeable, confounding, and a bit scary. Discretion is the better part of valor here. Resist getting sucked into the financial non-sense that is currently in abundant supply. Live your life, express gratitude, turn off the news, enjoy your loved ones – time is fleeting.

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[1] MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary Income/Growth accounts under management for at least one full month in 2021. These accounts represent 94% of MCS's discretionary assets under management as of 03/31/2021 and were invested primarily in US stocks and bonds (12% of client assets on 03/31/2021 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Barclays Capital US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or particular needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

[2] See: https://hbr.org/2021/02/the-spac-bubble-is-about-to-burst

Getting Higher Returns on Cash

So, so frustrating… The deck has been stacked against the prudent investor.

Cash offers stability in a crisis: an oasis of calm that lets the investor evaluate what's happening and pick their spots when investments and emotions are being whipped around.

Zero return on cash is designed to force investors into choices they would not otherwise make. There's a term for it "Financial Repression" - it's institutionalized financial abuse. Google the term if you'd like to learn more.

Also see: https://www.imf.org/external/pubs/ft/fandd/2011/06/Reinhart.htm

I am about 1/3 the way through a project to identify banks offering high yield FDIC insured deposits while giving us an easy way to move funds back and forth from Schwab. Identifying higher advertised yields is easy, confirming the commitment to maintaining higher yields (no teaser rate) and having an electronic infrastructure to efficiently shift funds between Schwab and the target bank is the hard part. I will keep you informed on our progress.

What About Inflation?

My industry actively promotes some misconceptions about inflation. Mark Twain's quote "lies, damned lies and statistics" applies here. Why have investors have been programmed to believe that their returns must keep up with CPI inflation, otherwise they will go backwards!?

The reason is simple: it encourages risk taking, which is extremely profitable for Wall Street.

But what is inflation, really?

There are different ways to define it (four), and there are different types of inflation (Google "Types of Inflation" and you can see what I mean). Or, go to this article to learn about thirteen types of inflation: https://www.thebalance.com/types-of-inflation-4-different-types-plus-more-3306109.

The media generally reports on the US Bureau of Labor Statistics' Consumer Price Index (CPI), which represents the costs of a 'basket' of goods and services. Roughly 33% of this index represents a rental equivalent, not home prices. For those of you who own your home, the rental equivalent portion doesn't impact you. Your net worth goes up when real estate prices inflate, hence a rise in inflation due to rent increases does not affect you.

On the other hand, for someone married with two kids, making $42k a year ($20 per hour) and renting because a home is unaffordable, CPI-measured inflation does hurt. In fact, it likely understates the cost-of-living pain because other elements of the CPI 'basket' (food, gasoline, and health insurance) are big expenses in relationship to their budget.

The richer you are, the less meaningful the CPI is because the CPI expense categories become a smaller and smaller portion of your budget. Yet, financial planners are taught to plug the CPI into someone's expenses to show them what their life will cost in the distant future. It's nonsense. A person with $2-3 million dollars does not spend the same proportion of their budget on food, clothing, rent, etc. as a person with $30,000.

The two biggest inflation risk to wealthy people are:

- Inflation surprises on the upside and interest rates rise to counter inflation, bashing the prices of stocks and long-term bonds.
- Their personal inflation rate: the rate at which they increase their personal cost of living by the choices they make. The good news is they can control it! The bad news is that high lifestyle inflation can make it impossible to save enough to be financially secure.