Traub Capital Management
Quarterly Outlook Q1 2021

Another Bumpy Ride

The final quarter of 2020 continued the bumpy ride in the equity markets – up 5%, down 9% and finishing up 11% for the quarter. For the year, it was the same story – up 5%, down 35% then up 70%. If you are reading this outlook, you already know that 2020 was a year of dichotomy – a disaster for the Main Street economy, contrasted with a surprisingly good year overall for stocks and bonds.

The coronavirus caused great disparities between different portions of society as well as produced great disparities in the market impact for various individual securities. The economic carnage for earned income was extensive throughout the entire year. By contrast, the S&P 500 suffered a major downturn in February and March only to rebound sharply and finish up 18% including dividends for the year. That said, the gains were somewhat driven by the largest stocks. Facebook, Amazon, Apple, Microsoft and Google make up over 1/5 of the S&P 500, and contributed about half the index's return. The average stock in the S&P 500 was up "just" 12%, while the less tech oriented indices of the Dow Jones Industrials and Russell 1000 Value Index gained only 7% and 3%, respectively.

While the downturn was technically a bear market as defined by a decline of over 20%, the decline had none of the usual trappings of a bear market – that grinding weakness; driven by deteriorating economic conditions that begin slowly, and continue to squeeze out any possible upturn, then drop quickly at the end as investors simply lose hope. The 2020 decline looked very much like a magnified correction – a sharp decline followed by a quick, sharp recovery as investors looked to a better economic picture within the forward looking horizon of the market.

Underpinning the brighter outlook now are a number of factors including the arrival of a COVID-19 vaccine in large quantities, economic support of central banks around the world, and the positive sloping interest rate yield curve coupling with very low interest rates. Let's look at how the foundation for a brighter outlook impinges on our forecast for 2021.

Economic Outlook

By all counts, 2021 should shape up to be a better year economically (and in many other ways) than 2020 with the coronavirus vaccine soon available in large quantities, more people back to work, less political uncertainty, better corporate earnings, and better productivity as people wind up adopting the better parts of the coronavirus induced disruption.

Compared to 2020, we are expecting growth in real GDP of over 4% for 2021. By the third quarter of 2021, GDP should be in new record territory, passing the 2019 peak. By the end of 2021, vehicle sales in the US should be running at an annualized pace of over 16 million. Housing starts should continue to be very strong, running at an annualized rate approaching 1.5 million by the end of 2021 and holding that rate through 2022.   Housing strength compares to an annual housing start rate of 1.3 million in 2019.

Interest rates will remain historically low and inflation will start to grow, but we don't expect to get notably above 2% at any point this year. The Fed has already stated its intent to keep a lid on interest rates and there will likely be no inflation drivers to dissuade them from this belief.

Unemployment will remain at elevated levels of over 6%, tailing off slightly from today's 6.8% and personal savings will remain historically high, but declining somewhat from the 15+ percent we have seen in the closing months of 2020 as the government stimulus payments wind down.

Housing Starts

Housing starts remain a bright spot in the economic picture and spending on new homes accounts for about 4% of the country's GDP. The coronavirus has reshaped today's working environment. Work from home means that people want nicer homes with space for a real office area that is separate from family space. The appeal of city life has declined, making urban living less desirable. Housing prices, and single-family houses in particular, have shown the biggest price gains since 2014 and are up 8% on average across the country from a year ago. Various areas of the country, as you would expect, have seen housing prices up considerably more than the average. Mortgage rates continue to be low following the overall interest rate patterns. The cost of working has declined as commuting and clothing costs decline. High personal savings rates add to the equation. It adds up to a strong housing market and one that is not likely to abate in the next few years.

Vehicle Production

Sixteen million cars and light trucks for 2021 and 2022 matches the numbers for 2019, which was a strong year for vehicle sales and accounts for another 4% or so of the country's GDP. The same forces that are driving housing are contributing to the demand for vehicles. The newly added dimension of personal space, less city living combined with less traffic makes vehicle ownership more desirable. These underpinnings are not going away.

Money to Spend

While the coronavirus has made a very large detrimental impact on great portions of our society, the overall personal savings rates soared in 2020. In contrast to the newspaper stories about individual hardship, which are no doubt true in those cases, many of the stimulus payments wound up in bank and investment accounts as the velocity of money declined markedly. Once people can get out, the savings will also start coming out of the woodwork. By the end of the year all this money might actually start to chase fewer goods and start inflation back up, but it is too early to tell for sure. In any event, inflation will remain sufficiently low this year to not tempt the Fed to raise interest rates.

On a note similar to personal savings, the cash balances of corporate, non-financial entities has continued to build steadily, now totaling $1.7 trillion, up from $180 billion in 2009. This cash on hand is money to be spent to invest in the future.

Interest Rates

There is simply nothing on the horizon which points to higher short-term interest rates and the low rates we see today are likely to persist for quite a while. These low rates are part of a positive economic feedback loop. Lower rates mean cheaper mortgages, lower corporate debt carrying costs and lower cost for governments to carry debt. Lower rates and persistently low rates means the incentive to hold high quality (and thus low yielding) bonds goes down, leaving funds available to purchase stocks, and potentially high dividend yield stocks as we explain further below. Further, low interest rates support lower earnings yields and higher price earnings ratios, which we have already seen expand significantly.

Increases in interest rates are driven by increases in inflation. The very high rates of inflation in the early 1980's were driven in large part by the enormous increase in the price of oil. In 1970, oil was under $3 per barrel. Ten years later it was over $30 per barrel, fully ten times as much. It took a while for the impact to ripple through society, but energy costs were a substantially greater percentage of GDP in 1980 than is the case today. The ten-fold increase in cost of a large part of GDP touched off the inflation and high interest rates of the period.

There are no similar inflation drivers on the horizon today. Workplace productivity continues to improve with copious additions of technology. Continuing unemployment rates of over 6% means plenty of workers are available and wages are not driving inflation. The normal inflation experienced with enormous additions of money to the money supply has evaporated as those money supply additions have to a large degree gone to savings and investments. Even something as destructive as the coronavirus has not catalyzed high inflation.

In 1981 the 10-year treasury interest rate peaked at nearly 16%. Today it is about 1%. Bond prices go up as interest rates go down and it has been a 40-year bull market for bonds as that interest rate fell consistently over the 1981 to 2020 period. That historic bull market for bonds is done and the end of the very long-term bull market in bonds will have substantial implications for stock prices as we note below.

Stock Market Gains

A year ago, the analysts' consensus was for an overall gain of 5.5%. Our forecast was for "an increase of over 8% and the possibility of higher or possibly substantially higher returns."

We did not foresee the COVID -19 induced drop and while Main Street is still very much under the COVID-19 cloud, it appears that markets do not foresee it as problematic to economic recovery from here.

At this juncture, the analysts' consensus for 2021 is a gain of 11% including dividends. As with last year's year-end outlook, we continue to be optimistic and believe that a gain for 2020 of 11% is realistic. What follows is our rationale for the optimistic outlook.

Earnings Increases

The S&P 500 companies should increase their earnings over 23% in 2021 compared to 2020. This earnings increase for 2021 is already priced into the market. To see where the market is likely to be a year from now, we need to look at earnings in 2022. For 2022, we expect a further earnings increase of 8.5%. Maintaining today's P/E ratio to forward earnings would call for a similar gain of 8.5% in the S&P index for 2021. Add in about 2% for dividends and we are roughly at the 11% consensus.

The Stock Market

In addition to the economic outlook, low interest rates and increased earnings, there are a number of other factors at work that will impact on the overall stock market returns. Notably, these factors are: declining uncertainty, increased use of technology to improve worker productivity, and the impact of low interest rates, which should impact dividend paying stocks as well as having a positive overall impact on valuations. These are discussed below.

Declining Uncertainty

Compared to a short time ago, overall uncertainty in the world has decreased. Our elections, thankfully, are over. The Presidential election is certified. The Democrats control both houses of Congress, but by the slimmest of margins, particularly in the Senate. We have seen a fair amount of disagreement even among those in Congress that are in the same party, so consistent votes just along party lines will not be easy to achieve for either party. Biden is a centrist. The next election is the midterms where the party of the sitting President normally loses seats in Congress.

It all adds up to not too much getting done in Washington. The prospects for sweeping legislation are low given that it is normally a difficult process to pass legislation even with congressional majorities far larger than what the Democratic Party enjoys today. Couple the normal legislative difficulty to general disagreements within members of the same party and put it all on top of a power structure that has a very delicate balance. It adds up to a realistic projection that new legislation to significantly reallocate wealth will be similarly difficult to pass.

In foreign policy, it is hard to imagine that Mr. Biden will be more uncertain than was Mr. Trump. We will see more calculated policies domestically as well as internationally. Government by Twitter should disappear.

On the coronavirus front, newspaper stories continue to run with scary headlines about botching the vaccine rollout with fingers pointed to vaccine manufacturers, to the Federal Government's Warp Speed program, to local hospitals to State governments. There are no-doubt various glitches in the process and the first weeks were disappointing, but our informal surveys show that vaccines are available and that they are now getting to people that have been prioritized. You would expect to see some glitches in the process, but these will be addressed and they will be worked out.

The economic factors will couple with a workable vaccination program to further reduce uncertainty. Markets do not like uncertainty and less of it results in higher values.

Dividend Paying Stocks

All the money that has flowed into bonds in the last few years should finally realize that bond yields are very low. The likely option for interest rates are for them to stay low which gives a paltry yield, or to go higher, in which case the value of the bond would decrease. The 40-year bull market in bonds is over. Bond investors are going to see very low income yield, coupled with the prospect of declining bond values. It is not a pretty picture for high quality bonds, such as treasuries, in general.

We should expect that some of the funds that have been flowing into bonds in the past several years will begin to flow into dividend paying stocks of companies with strong balance sheets. A number of solid companies are paying a dividend that exceeds 4%. For investors with long-term time horizons, earning 4% plus the possibility of increasing value of the stock should be preferable to earning 1 to 2% in a bond with the prospect of a decline in the face value of that bond.

The Lasting Impact of the Coronavirus

We are not going to be able to divine all the impacts of the coronavirus, but some things are clear. First, it is a giant disruption in the way people work. Some of that disruption will be determined to be a benefit and those aspects will stay part of the economy going forward. We expect less commuting, a decline in central offices, lower traffic on the highways, more work from home and more dependence on technology.

The second lasting impact will be "remote everything". You could lump "remote everything" in with increased dependence on technology or better productivity and that may be fair. It can also lower costs, and dramatically so for many doctor "visits" going to telehealth visits, customer visits becoming Zoom meetings and a vast increase in on-line ordering. These aspects of remote everything are not going to go away. Remote everything is completely dependent on high-speed internet connections and data security.

The third lasting impact from the coronavirus will be on drug development. Messenger RNA will become a major breakthrough in drug development allowing quicker development process and the possibility of tailoring drugs to individuals or to a group of individuals with similar genetic structures.

Market Valuations

Quantifying a market valuation is the tricky part. The P/E ratio on forward earnings today is 22x, which is considerably higher than its 10-year average of 17.5x. But is today's 22x the "right" value or is the historic average "right". During the "dot-com" era of 2000, just before the dot-com crash, the technology sector had a "normalized" P/E ratio of 68.6. Today that same ratio is 33.7[1].

The open options for alternative investments must also play into part of the picture. Today, those alternative investments are bonds with very low interest rates and the prospect of declining principle values. In contrast, over the past 10 years, bonds paid decent yields and enjoyed overall gains in the underlying values. The lack of

[1] Source FactSet, November 23, 2020. "Normalized" P/E excludes the extreme outliers on both the high and low sides.

real alternatives argues for higher than normal P/E ratios continuing and that is what we expect. In addition, with the government handing many people "free" money, a meaningful amount of that "found" money is finding its way into the stock market leading to a fairly speculative market. If this continues, we could see further expansion in market P/E ratios, which would boost stock market gains higher than the 10.5% noted above.

While it is possible that the forward P/E could go higher, risks are higher than normal and risks could continue to grow if increases in valuations get stretched further and further above normal. Should the market revert back to the historical average of 17.5, it would represent a significant decline of about 20% from current levels.

Tesla

We should mention a quick word about Tesla. As most of you know, Tesla has recently been added to the S&P 500 average and it also enjoys a P/E ratio of about 1,500 times. Tesla constitutes about 1.8% of the S&P 500. The last time a stock with such a large valuation and weight was added to the index was near the peak of the tech bubble in late 1999, a company called JDS Uniphase. I'm sure most of you say, "Who?" Yes, that stock nosedived within a year and has never recovered close to its price where it was added (it later split into Viavi and Lumentum). We believe that Tesla is overvalued by a large margin, but admittedly we have felt so for a while and while it might indeed be significantly overvalued, the market has not agreed with our assessment. Bringing Tesla down to a P/E ratio of Amazon, would take somewhere around 1% of the gain out of the S&P 500. This scenario could develop and put a modest damper on market gains in 2021. To help minimize the potential decline in Tesla, along with reducing risk from several other extreme valuations of growth stocks, we have constructed your portfolios with stock and fund investments that are tilted to our historic belief that value stocks will show higher returns over the long-run (as has been the case in history). Regardless of the value of their cars and revered leader Elon Musk, we believe that the stock is vastly overvalued.

Conclusion

In spite of the coronavirus desecration of the world economy and the deplorable circus now ongoing in our nation's capital, there are very good reasons to be optimistic going forward. We are very hopeful that 2021 will become a much better year for the average American. We expect to see good returns on equities, particularly for high and growing dividend stocks (which do correlate with value stocks).