Traub Capital Management
Quarterly Outlook Q2 2021

April 7, 2021

Q1 in the Books

As the first quarter of 2021 wound down, the biggest news story was about a large container ship being stuck in the Suez Canal. This is no doubt a problem, particularly for other vessels that want to use the waterway, but it isn't the same magnitude an issue as, say, coronavirus, vaccination rates, economic stimulus, or imminent nuclear war from a number of sources, etc. You might really think that the economy had settled down for a smoother ride going forward.

While the overall economic picture in Q1 was very close to what we thought it would be going into the year, there was a significant market drop at one point during the quarter and we will see valleys like this again going forward. The spike was about 5% down, resulting from a bump up in inflation along with increases in interest rates on longer-term debt obligations. By the end of the quarter, the market seems to have forgotten about this blip, but you should not, because you will see it again – and more than once in the next few years.

Compared to the Q1 Outlook

The first quarter of 2021 finished up in line with our expectations – strong economic growth. Real GDP growth was 6.7%, vs. our expectation of 4%. All the other indicators came in at very healthy numbers, with the exception of unemployment, as we expected. The S&P 500 rose from 3,756 to 3,973 for an increase of 5.8%, which is a bit stronger than we had anticipated. An overall gain for the year to our predicted 4,169 is very realistic and perhaps a bit conservative as things stand today.

We were very pleased to see the especially strong performance of value-oriented stocks and dividend paying stocks in particular in the first quarter. These results were very much in line with our thinking and forecasts at the beginning of the year.

We were a bit optimistic on longer-term interest rates. Inflation bumped up to 2.7% in the first quarter, higher than our expectations. This bump was quickly extrapolated and it caused a degree of uncertainty and a concomitant increase in longer-term interest rates. We do expect to see inflation come down to under 2% for the next three quarters, however, which should put a lid on the speculation. We will expand on the direction of inflation and interest rates below.

The COVID 19 vaccine is available in large quantities with over three million shots a day being administered in the US. While vaccinations at that rate are very good, the percent of fully vaccinated people in the population is still only about 20% and not quite enough to start making a big dent in the spread of the virus. The rate that the economy is opening up is faster than the vaccination rate, resulting in somewhat of a recent uptick in infections, but still a very significant reduction from the number at the beginning of the year. Epidemiologists and hospital ICU's will still focus on the disastrous effects of the virus, and headline stories will remain on these effects. However, the benefits of opening up the economy are massive and will also start to become apparent.

Headlines aside, the vaccination rate is sufficient for the market to be looking beyond the uptick in infection rates. The prospect of further lockdowns, at least in this country now seems to be very remote.

Economic uncertainty is declining and an enormous economic stimulation bill was passed into law, giving consumers more money to spend on an overall basis. We will also explore the stimulation in further depth below.

Overall earnings of the S&P were very strong and very much in-line with our expectations. Although our forecast of a 23% increase in earnings for 2021 vs. 2020 was considered to have been very optimistic at the beginning of the year, it appears now that it should be easily met.

Economic Outlook

As we head in to the second quarter of 2021, the economic picture, particularly in the US is very bright and improved. Although we were more optimistic than most at the beginning of the year, the overall economic picture has brightened more than we realized.

Where we had seen real economic growth for 2021 to be 4% at the beginning of the year, we now see real GDP up fully 6%. The US has seen this kind of growth only twice since the end of WWII. The first instance was in the 1960's with the enormous tax cuts of the Kennedy era combining with the large defense spending increases to finance the Vietnam War. The second resulted from the tax cuts (and much higher defense spending) that were instituted with Reaganomics in the 1980's. In contrast, for the nearly two-decade period from 2001 through 2019, real growth in US GDP averaged just a bit over 1.6%.

And it is not just the recovery in GDP from the shock of the coronavirus in 2020. GDP for 2021 will surpass that of 2019 by a wide margin. Significant growth will touch every sector of the US economy although not entirely to the same extent. In particular, the US energy sector will not see the same kind of growth. But most stocks in this sector have already declined significantly over the past couple of years in anticipation so the stocks in the energy sector should see some improvement from their present levels.

But more importantly than overall growth in GDP, for the stock market at least, are corporate earnings. Here, the S&P earnings for 2021 should be 11% higher than seen in 2019 and growing yet another 13% in 2022. Earnings growth will come not only from overall GDP growth, but also from improving efficiencies as tremendous additions to technology and on-line everything continues, resulting in much lower labor costs per unit of output.

The downside of the economic picture is on the personal level. While the stock market will be looking at the substantial overall growth and, in particular, the growth in earnings, the bright picture does not extend to everyone. Unfortunately, a portion of the workforce in the US is going to be left behind. Those left behind will struggle with rents and basic services. Businesses are going to be looking for people with skills – particularly skills in technology and healthcare. So while unemployment will remain higher than "full employment", there will also be an enormous number of unfilled positions by this time next year. The needs of those left behind are real and there will be a continued need to address these, but the overall economy is not going to need stimulus, so the issue will remain a thorny one.

Inflation and Interest Rates

The next tricky issue will be inflation and it's tied in with longer-term interest rates. Short-term rates are set by the Federal Reserve (Fed). The Fed, very much in contrast to its historic stance has stated its intention to keep these short-term rates very low and for some time. Long-term (i.e. 10 year to 30 year) rates, however, are set in "the market", which means they are set by people responding to various stimuli.

One thing that economists like to do is to anticipate what will happen based on what has happened. They set up elaborate cause-effect models. One thing, however, that economists don't readily grasp, is that relative cause-effect relationships change and evolve over time because these relationships are all set by people. How people react is not a constant. It changes. At one time, economists had a bedrock principal of inflation based on the relationship between unemployment and inflation, known as "The Phillips Curve". Loyal readers of these outlooks know that we questioned and repudiated the Phillips Curve logic years ago. It is interesting that the Fed itself has now done the same thing (although we doubt the Fed is reading our outlooks and organizing their decisions solely based thereon!)

The next historical bedrock relationship is between the money supply and inflation, i.e. more money chasing the same amount of goods and services simply meant that every one of those goods and services will become more expensive or "inflated". This money supply and inflation relationship relies on people spending money at a fairly constant rate. Clearly, if the supply of money is increased and that money just goes into a savings account, the extra money does not chase anything and nothing will become more expensive.

What we have coming out of the pandemic is a "new economic order". People are not reacting on the backside of the pandemic as they reacted before it. Just how similar or how different those reactions will be is very much up in the air. The recent rounds of economic stimulus packages have simply put an unprecedented amount of money in the money supply. Just how people will react and just how much inflation will ensue is quite unknown. As a result, there is a wide variation in inflation projections.

What we believe is that the inflation road going forward will be bumpy. The first quarter of 2021 saw inflation over 2% from a year ago, mostly due to the deflation (or at least the downward pressure on inflation) we saw going into the pandemic a year ago. The market reaction to that bump in inflation was to extrapolate and those extrapolations drove up the yields on longer-term bonds (10 and 30 year.)

For the next three quarters, we expect to see much reduced inflation, at under 2%. We expect to see another bump in the first quarter of 2022, followed by a subsiding over the rest of 2022. The important point here is not the exact timing of the inflation bumps, but the fact they are out there and will pop up at some point.

When those bumps in inflation pop up, we can expect a similar rise in 10 and 30-year interest rates and an adverse stock-market reaction, particularly for growth stocks whose far in the future earnings become discounted at a higher rate. The stock market will gradually forget the bumps, but the fixed income market may not. And over the forecast horizon, out to the end of 2022, we expect to see gradually rising 10 year and 30-year interest rates.

A likely steady increase in longer-term interest rates will create a weak market for long-term high quality bonds since the value of a bond goes down when interest rates rise. People may very well stem their appetite for bonds. We have positioned our bond portfolios generally to have shorter maturities and less interest rate risk than the standard bond indices. We still have some high quality bonds for insurance as these will hold up well in a "risk-off" environment like we saw last March. But many of our bond holdings will benefit from a continued strong global economy via investments in areas like floating-rate loans and emerging market debt.

The Stock Market

Going forward, there are several countervailing trends. Earnings for the S&P 500 stocks will be up markedly – increasing almost 30% in 2021 compared to the depressed values in 2020. For the two years 2020 and 2021 the earnings increase should be a compounded 5% and then adding another 13% increase for 2022. Offsetting the earnings increase will be an increase in interest rates. The increase in interest rates will drive down the relatively high price earnings multiplier.

As of April 6, the S&P 500 stands at 4,074. The consensus price earnings ratio is 21.5x. Our earnings forecast for the next 12 months is $190. The consensus earnings ratio gives a market price of 4,085 (190 x 21.5), which is just about where we are as of April 6. For 2022, our earnings forecast is $209. By year-end, we expect that increased interest rates will bring down that earnings ratio to about 20x. At 20x forward earnings, we see some further potential growth for the S&P to 4,160. A value of 4,160 would match what looked like an optimistic forecast of 11% that we made at the beginning of the year.

Conclusion

There are any number of reasons why "the market will plummet" according to the headlines. We, however, believe there is good reason and good justification for the current levels, based primarily on the earnings outlook and the declining levels of uncertainty. We cannot rule out bumps downward, particularly in response to a rocky outlook for inflation. These downward bumps can come at any time, so it is very possible that at year-end we may be in one of those valleys. If so, we believe we will scale out of the valley relatively quickly and that increased corporate earnings will continue to support growth in the market. We also believe that dividend stocks and our normal emphasis on value stocks will provide a good foundation for portfolios.

As always we appreciate the continuing confidence you have shown in Traub Capital and look forward to working with you in the coming years.